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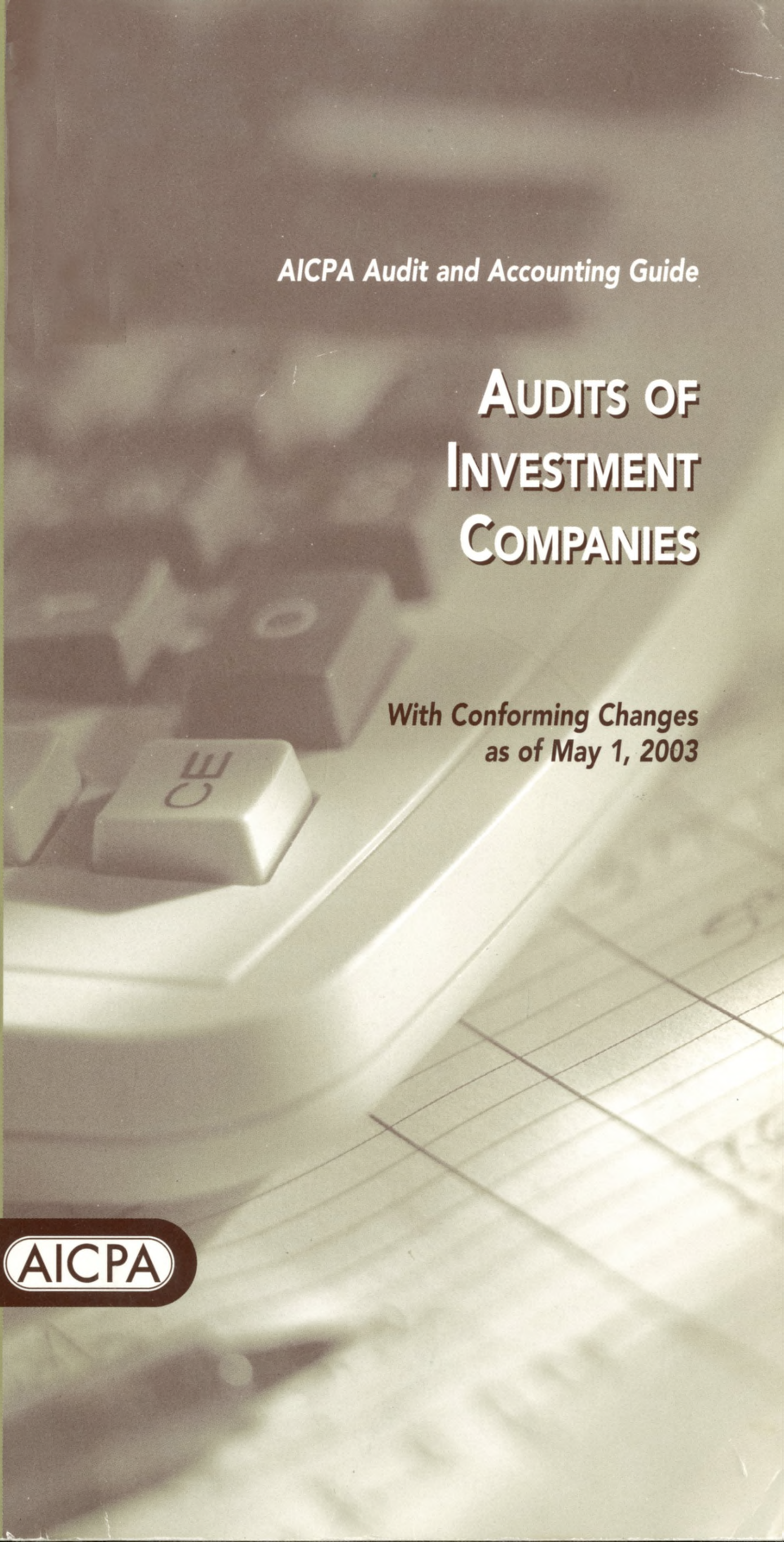
American Institute of Certified Public Accountants. Investment Companies Guide Task Force

AICPA Audit and Accounting Guide

Audits of Investment Companies

With Conforming Changes as of May 1, 2003



American Institute of Certified Public Accountants

AICPA

AICPA Audit and Accounting Guide

AUDITS OF INVESTMENT COMPANIES

With Conforming Changes as of May 1, 2003

This edition of the AICPA Audit and Accounting Guide *Audits of Investment Companies,* which was originally issued in 2000, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page vi). The changes made in the current year are identified in a schedule in appendix G of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the AICPA Investment Companies Guide Task Force to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in acccordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that is establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board. However, as noted in footnote 4 to chapter 1 and footnote 20 to chapter 2 of this Guide, the Financial Accounting Standards Board has expressed concern regarding the clarity of the scope of the Guide and the use of a blockage factor in estimating the fair value of certain unrestricted investments that have a quoted market price in an active market. As a result, AcSEC is undertaking two separate projects to address those concerns. Until those projects are finalized—

- An entity should consistently follow its current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to companies that are controlled by the entity. Further, FASB expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the Guide. Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments.
- If it was the entity's accounting policy in investment company financial statements issued for fiscal years ending on or before May 31, 2000, to apply a blockage factor to estimate the fair value of certain unrestricted investments that have a quoted market price in an active market, the entity may continue to apply that policy to those and similar investments. Otherwise, an entity may not elect to adopt such a policy pending completion of the AcSEC project on this matter or the FASB's project on measuring financial instruments at fair value.

AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

Auditing guidance included in an AICPA Audit and Accounting Guide is an interpretative publication pursuant to SAS No. 95, *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretative publications are issued under the authority of the Auditing Standards Board.

The auditor should identify interpretative publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretative publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

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The AICPA gratefully acknowledges Richard Grueter, Kenneth B. Robins, and Jami D. Waggoner for their assistance in the review of the conforming changes for the May 2003 edition of this Guide.

This edition of the Audit and Accounting Guide *Audits of Investment Companies* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. This Guide reflects relevant guidance contained in authoritative pronouncements through May 1, 2003:

- FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
- FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of the EITF held through January 2003
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*
- SAS No. 101, *Auditing Fair Value Measurements and Disclosures*
- SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*
- SSAE No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10,* Attestation Standards: Revision and Recodification

Users of this guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this guide.

Substantial Changes to Audit Process Proposed

In December 2002, the AICPA's Auditing Standards Board (ASB) issued an exposure draft proposing seven new Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing and extent of audit procedures performed in response to those risks.

(continued)

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

The proposed SASs would be effective for audits of financial statements for periods beginning on or after December 15, 2004, in order to allow time for auditors to revise their methodologies and train their personnel to plan the initial application of these standards to their audits. Readers can access the proposed standards at AICPA Online (www.aicpa.org).

Preface

Purpose

This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist investment companies in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements.

Applicability

This Guide describes operating conditions and auditing procedures unique to the investment company industry and illustrates form and content of investment company financial statements and related disclosures. Chapter 1 discusses the kinds of companies considered to be investment companies to which the provisions of this Guide apply.

Because many investment companies are subject to regulation under the Investment Company Act of 1940, rules under that Act are discussed extensively in this Guide. However, the rules, regulations, practices, and procedures of the investment company industry have changed frequently and extensively in recent years. The independent auditor should keep abreast of those changes as they occur.

Limitations

This Guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of investment companies. This Guide is directed primarily to those aspects of the preparation and audit of financial statements that are unique to investment companies or those aspects that are considered particularly significant to them.

Impact on Other Literature

This Guide supersedes the AICPA Audit and Accounting Guide *Audits of Investment Companies (with conforming changes as of May 1, 1998)*, and Statement of Position (SOP) 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*.

This Guide incorporates the following authoritative material specific to investment companies:

1. SOP 89-2, *Reports on Audited Financial Statements of Investment Companies*
2. SOP 89-7, *Report on the Internal Control Structure in Audits of Investment Companies*
3. SOP 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies*
4. SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies*
5. SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*
6. SOP 95-3, *Accounting for Certain Distribution Costs of Investment Companies*

7. SOP 01-1, *Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*
8. SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*

Summary of New Accounting Standards

This Guide requires the following:

1. Premiums and discounts on debt securities should be amortized using the interest method. The prior Guide was silent on whether funds should be required to amortize premiums and discounts on debt securities. (See paragraph 2.52.)
2. Guidance is provided in paragraphs 8.17 through 8.26 for the accounting for organization costs and offering costs as follows:
    a. Types of costs that should be accounted for as organization costs and offering costs are listed.
    b. The requirements of SOP 98-5, *Reporting on the Costs of Start-Up Activities*, to expense organization costs as incurred are discussed.
    c. Offering costs for closed-end funds and investment partnerships should be charged to paid-in capital upon sale of the shares or units. Offering costs for open-end funds and closed-end funds with a continuous offering period should be accounted for as a deferred charge until operations begin and thereafter, amortized to expense over twelve months on a straight-line basis. This guidance does not change prevailing industry practice nor does it differ from that provided in the prior Guide.
    d. Offering costs for unit investment trusts (UITs) should be charged to paid-in capital on a pro rata basis as the units or shares are issued or sold by the trust (when the units are purchased by the underwriters). The prior Guide did not provide guidance on accounting for offering costs of UITs.
3. Paydown gains and losses on mortgage- and asset-backed securities should be recorded as adjustments to interest income, not as realized gains and losses. (See paragraph 2.52.)
4. Guidance is provided in paragraphs 7.49 through 7.51 on the accounting for payments by affiliates and corrections of restriction violations. Affiliates may make payments to a fund for one of the following reasons:
    a. To reimburse the effect of a loss (realized or unrealized) on a portfolio investment, often caused by a situation outside the fund's, or its affiliate's, direct control
    b. To make the fund whole relative to a realized loss on a portfolio investment directed by the fund adviser in violation of the fund's investment restrictions

The Guide requires both types of payments as well as any gain or loss realized on an investment restriction violation to be combined and reported as a separate line item in the statement of operations. Each type of payment and any gain or loss on investment restriction violations should be disclosed and described separately in the notes to the financial statements. In addition, the effect on total return of the payments and any gain or loss on investment restriction violations should be quantified and disclosed in a manner similar to disclosure of the effect of voluntary waivers of fees and expenses on expense ratios.

5. A liability for "excess expense" plans should be recorded if, and to the extent that, the established terms for repayment of the excess expenses to the adviser by the fund and the attendant circumstances meet the criteria of (a) Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 36, and (b) FASB Statement No. 5, *Accounting for Contingencies*, paragraph 8. In most instances a liability for excess expenses under such plans will not be recorded until amounts are actually due to the adviser under the reimbursement agreement because it is not likely the criteria of those paragraphs will be met at an earlier time. (See paragraph 8.05.)

6. New guidance has been provided for accounting, reporting, and auditing of multiple-class funds, master-feeder funds, and funds of funds. The new guidance is primarily derived from Securities and Exchange Commission (SEC) rules, letters, and positions in exemptive orders and prevailing industry practice. (See chapter 5.)

7. Certain financial statement presentation and disclosures including the following:

   a. The prior Guide required investment companies to disclose a complete listing of investments consistent with the SEC's disclosure requirements of Regulation S-X.* This Guide defines the reporting requirements for two groups of investment companies: investment companies and nonpublic investment partnerships.** Nonpublic investment partnerships are required to follow the reporting requirements of SOP 95-2, as amended by SOP 01-1. As indicated in paragraph 7.10 of this Guide, other investment companies should disclose the following in the absence of regulatory requirements:

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* In December 2002, the SEC proposed for comment amendments to Regulation S-X which would permit most investment companies to provide summarized schedules of investments in shareholder reports, along with tabular or graphical data on the industry, geographic, credit quality, or maturity profiles of the portfolio. Money market funds operating under SEC Rule 2a-7 would be allowed to completely omit a schedule of investments from their shareholder reports. A complete schedule of investments would continue to be required to be filed in Form N-CSR and to be made available to shareholders upon request. The comment period on this proposal closed in February 2003. Readers should be alert of any final regulation.

** In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

A final pronouncement is expected to be issued in the fourth quarter of 2003. A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

1. Each investment (including short sales, written options, futures, forwards, and other investment-related liabilities) whose fair value constitutes more than 1 percent of the fund's net assets
2. All investments in any one issuer whose fair values aggregate more than 1 percent of the fund's net assets
3. At a minimum, the fifty largest investments.

b. Investment companies presenting financial statements in accordance with GAAP should also include disclosure of financial highlights, which consists of per share operating performance, net investment income and expense ratios, and total return for all investment companies organized in a manner using unitized net asset value. For investment companies not using unitized net asset value, financial highlights should be presented and consist of net investment income and expense ratios and total return. (See paragraph 7.01.)

c. Total distributable earnings and total distributions (with returns of capital reported for tax purposes shown as a separate line item) may be presented in the statement of assets and liabilities and the statement of changes in net assets, respectively, with disclosure of the tax basis components of net assets and distributions in the notes to the financial statements. The prior Guide required separate reporting of the components of distributable earnings as undistributed net investment income, accumulated net realized gains or losses, and unrealized appreciation or depreciation, and separate reporting of distributions from each of the first two components. (See paragraph 7.01.)

Effective Date and Transition

The accounting and financial reporting provisions of this Guide that describe changes required by other new authoritative literature should be applied using the effective dates specified in that literature. Except as described below, changes in accounting and financial reporting required by this Guide shall be applied prospectively and shall be effective for annual financial statements issued for fiscal years beginning after December 15, 2000, and for interim financial statements issued after initial application. Earlier application is permitted. Restatement of previously issued financial statements is not permitted.

Paragraph 2.52 describes the required accounting for the amortization of premium and discount on debt securities. The effect of initially applying changes required by this Guide will not result in adjustments to the net assets reported in the financial statements. Rather, the cumulative effect of the change should be reflected as an adjustment to the disclosed amount of amortized cost of debt securities held as of the beginning of the year in which this Guide is first applied, based on retroactive recomputation of premium or discount from the initial acquisition date of each security. If the entity discloses the components of net assets in its financial statements, the cumulative effect of the change should also be reflected as an adjustment of the undistributed net investment income and net unrealized gains or losses as of the beginning of the year in which the Guide is first applied. Disclosure should be made in the notes to the financial statements of (1) the cumulative effect of the change to the amount of amortized cost of debt securities held as of the beginning of the year in which the changes required by the Guide are first applied, and (2) the effect of the change for the year of implementation on net investment income, net unrealized gains or losses, and net realized gains or losses as reported in the statement of operations. Additionally, the effect of the change for the year of implementation on the per share data and ratio of net investment income to average net assets as disclosed in the financial highlights table should be shown in a footnote to that table.

Paragraph 8.05 describes the required accounting for excess expense plans. The effect of initially applying changes required by this Guide with respect to excess expense plans should be reported as a charge or credit, as appropriate, in the statement of operations as a cumulative effect of a change in accounting principle.

Paragraph 8.21 describes those expenditures that are included in offering costs. Unamortized capitalized offering costs at the date of initial adoption of this Guide not meeting the description in paragraph 8.21 (and which are not organization costs subject to paragraph 23 of SOP 98-5) should be reported as a charge in the statement of operations as a cumulative effect of a change in accounting principle. Those expenditures that are organization costs subject to the provisions of paragraph 23 of SOP 98-5 incurred prior to the date of initial application of SOP 98-5 should be reclassified to organization costs and amortized as described in that SOP.

Paragraph 8.24 describes how offering costs of unit investment trusts should be charged to paid-in capital. Unamortized capitalized unit investment trust offering costs at the date of initial adoption of this Guide should be adjusted to conform with the guidance in paragraph 8.24 with the cumulative effect of the change charged or credited directly to paid-in capital. The effect of the change should be disclosed in the notes to the financial statements.

Entities are not required to report the pro forma effects of retroactive application in adopting this Guide.

Introduction

This Guide has been written with the assumption that readers are proficient in accounting and auditing in general but not necessarily familiar with the investment company industry. Accordingly, the Guide includes extensive investment company industry background and explanatory material.

Chapter 1 provides background information and terminology that is intended to help the reader better understand the industry.

Chapters 2 through 4 and chapter 8 focus on the major financial statement components that have unique accounting and auditing requirements for investment companies.

Chapter 5 focuses on unique accounting, operational, and auditing aspects of complex capital structures of investment companies, including multiple-class funds, master-feeder funds, and funds of funds. Illustrative financial statements are presented for multiple-class funds, master funds, feeder funds and funds of funds.

Chapter 6 focuses on two distinct aspects of taxes for investment companies: financial statements and other matters, and taxation of regulated investment companies.

Chapter 7 focuses on financial statement presentation and disclosure requirements of investment companies. Additional disclosures required by the Securities and Exchange Commission (SEC) for registered investment companies and generally accepted accounting principles (GAAP) disclosure requirements are identified. Illustrative financial statements of a typical open-end management investment company are presented.

Chapter 9 provides background information and unique matters related to UITs. This chapter also contains illustrative financial statements for these entities.

Chapter 10 provides background, product design, operational, and regulatory information related to separate accounts of life insurance companies. This chapter also describes auditing considerations and contains illustrative financial statements for these entities.

Chapter 11 discusses reports on audited financial statements of investment companies, reports on internal control required by the SEC, reports on processing of transactions by transfer agents, reports on examinations of investment performance statistics, and other reports unique to the investment company industry. Numerous report examples are included in this chapter.

Chapter 12 provides basis for conclusions for significant new accounting standards.

A glossary of terms and several appendixes have been included to provide the reader with additional sources of information regarding the investment company industry. The appendixes are:

- Appendix A—Venture Capital and Small Business Investment Companies
- Appendix B—Computation of Tax Amortization of Original Issue Discount, Market Discount, and Premium
- Appendix C—Internal Revenue Code Worksheets
- Appendix D—Worksheet for Diversified Management Investment Companies
- Appendix E—Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies
- Appendix F—Illustrations for Separately Calculating and Disclosing the Foreign Currency Element of Realized and Unrealized Gains and Losses

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Glossary

Chapter 1

*The Investment Company Industry**

1.01 An **investment company**,[1] as used in this Guide, generally is an entity that pools shareholders' funds to provide the shareholders with professional investment management.[2] Typically, an investment company sells its capital shares to the public, invests the proceeds, mostly in securities, to achieve its investment objectives, and distributes to its shareholders the net income earned on its investments and net gains realized on the sale of its investments.**

1.02 The investment company industry is highly specialized, intensely competitive, and subject to specific governmental regulation, special tax treatment, and public scrutiny. Accordingly, before starting an engagement to audit an investment company's financial statements, an auditor should become familiar with the entity's business, its organization, and operating characteristics and with the industry's terminology, legislation, and, if applicable, the securities and income tax rules and regulations.**

Kinds of Investment Companies**

1.03 Several kinds of investment companies exist: **management investment companies, unit investment trusts (UITs), common (collective) trust funds, investment partnerships**, certain **separate accounts** of life insurance companies, and **offshore funds**. Management investment companies may be open-end funds, usually known as **mutual funds, closed-end**

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* In December 2002, AcSEC issued an Exposure Draft of a proposed Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The purpose of the proposed SOP is to clarify the scope of this Guide to assist preparers and auditors in determining whether the provisions of the Guide should be applied. This proposed SOP would amend the Guide by deleting paragraphs 1.01 to 1.06 and replacing them with specific guidance for determining whether an entity is within the scope of the Guide. In addition, this SOP would provide guidance for determining whether the specialized industry accounting principles of the Guide should be retained in the financial statements of a parent company of an investment company or an investor in an investment company that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. Entities that previously applied the provisions of the Guide, but that do not meet the investment company conditions in the SOP, would be required to apply the provisions of the SOP by retroactively restating the financial statements of prior fiscal years as if the Guide had not been applied. Entities that meet the investment company conditions in the SOP, but that previously had not followed the provisions of the Guide, would be permitted to adopt the provisions of the SOP either as the cumulative effect of an accounting change in conformity with Accounting Principles Board Opinion No. 20, *Accounting Changes*, or by restating the financial statements for any number of consecutive prior fiscal years. A final pronouncement is expected to be issued in the first quarter of 2004. Readers should be alert to any final pronouncement.

[1] Terms defined in the glossary are set in **boldface type** the first time they appear in this Guide.

[2] In this Guide, the term investment company refers to an entity with the attributes described in this chapter. This term is not used to conform with the legal definition of an investment company in the federal securities laws.

** In December 2002, AcSEC issued an Exposure Draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The proposed SOP may supersede guidance provided in this paragraph. See footnote * for more information.

funds, special purpose funds, **venture capital investment companies**, **small business investment companies (SBICs)**, and **business development companies (BDCs)**. Investment companies are organized as corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders), common law trusts (sometimes called business trusts), limited partnerships, limited liability investment partnerships and companies, and other more specialized entities, such as separate accounts of insurance companies that are not in themselves entities at all except in the technical definition of the **Investment Company Act of 1940** (the 1940 Act).

1.04 The accounting principles and auditing procedures discussed in this Guide apply to all investment companies.[3] Mutual funds and closed-end companies registered with the **Securities and Exchange Commission (SEC)** under the 1940 Act are the most common forms of investment companies and are required to follow many rules and regulations prescribed by the SEC.

1.05 Though many aspects of venture capital investment companies, including SBICs and BDCs, differ from aspects of other types of investment companies, the provisions of this Guide generally apply. (Venture capital investment companies are discussed in appendix A.)[4]

1.06 Investment companies discussed in this Guide are required to report their investment assets at fair value and have the following attributes:[5]

a. *Investment activity.* The investment company's primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.

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[3] This Guide does not apply to real estate investment trusts, which have some of the attributes of investment companies but are covered by other generally accepted accounting principles.

[4] The Financial Accounting Standards Board (FASB) expressed concern that the scope of the Guide may be unclear. Specifically, paragraph 1.05 of the Guide states that, regarding venture capital investment companies, "the provisions of this Guide generally apply," while paragraph 1.06 of the Guide lists the "attributes" of an investment company, which, when met, would require that the Guide be applied. Those two paragraphs may be interpreted as being contradictory and may have resulted in diversity in practice. FASB observed that the Guide provides specialized accounting guidance for entities within its scope, particularly regarding the entity's reporting of investments at fair value and not consolidating the accounts of certain investees. The AICPA Accounting Standards Executive Committee (AcSEC) Chairman has acknowledged that diversity in practice exists with respect to application of the scope of the Guide on investment companies. In December 2002, AcSEC issued an Exposure Draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies,* to address this issue. Until that project is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to subsidiaries that are controlled by the entity. The final SOP is expected to be issued in the first quarter of 2004. See footnote * for more information on this SOP. Further, the FASB has expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the Guide (see FASB Action Alert No. 02-14, April 3, 2002). Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments. For further discussion, please refer to the FASB staff announcement in the Emerging Issues Task Force (EITF) Topic No. D-74, *Issues Concerning the Scope of the AICPA Guide on Investment Companies.*

[5] See footnote 4.

b. *Unit ownership.* Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of **net assets** can be attributed.

c. *Pooling of funds.* The funds of the investment company's owners are pooled to avail owners of professional investment management.

d. *Reporting entity.* The investment company is the primary reporting entity.

History

1.07 The concept of investment companies originated in England in 1868 with the formation of the Foreign and Colonial Government Trust. Its purpose was to provide investors of moderate means with the same advantages as those of more affluent investors, that is, to diminish risk by spreading investments over many different securities. Massachusetts Investors Trust, the first mutual fund, was organized in 1924.

1.08 The investment company industry has changed considerably since its origin and has attracted insurance companies, brokerage firms, conglomerates, banks, and others as sponsors to perform advisory or distribution services. Initially, the industry was characterized by one- or two-person managements, relatively simple investment techniques, and rudimentary sales practices. Today, investment techniques are more sophisticated, and selling practices are more creative and aggressive. For example, in the 1970s tax-exempt and **money market funds** came into use, in the 1980s funds entered foreign markets, and in the 1990s funds have entered the derivative security markets, which has necessitated new investment expertise and increasingly sophisticated data processing capability. Fund organization structures have become more complex in recent years with the introduction of multiple class funds, **series funds** and master-feeder funds. These funds potentially provide greater flexibility to multiple markets such as retail customers (front-end load, level load, or **contingent deferred sales load [CDSL]**) and institutions.

Definition and Classification

1.09 The term mutual fund is the popular name for an open-end management investment company as defined in the 1940 Act. An **open-end investment company** stands ready to redeem its outstanding shares, based on net asset value, at any time. Shares of an open-end company routinely are not traded. Most open-end companies offer their shares for sale to the public continuously, although they are not required to do so. The price at which the shares of mutual funds are sold is determined by dividing each fund's net assets, stated at *fair value*,[6] by the number of its shares outstanding; the resulting **net asset value per share** may be increased by a **sales charge**, called a *load*, that provides commissions to the underwriter and **dealer**. Funds whose shares are sold at net asset value without a sales charge or that have a 12b-1 plan (see paragraph 8.08) that charges not more than 0.25 percent of average net assets per year (that is, 25 **basis points**) are known as **no-load**

[6] As defined in FASB Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, and as used in this Guide, fair value is the amount at which the security could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale. Under the terminology used in the Investment Company Act of 1940 (the 1940 Act), however, *fair value* is used to refer only to an estimated value determined in good faith by the board of directors for securities and assets having no readily available or reliable market quotation.

funds. Some funds or **classes of shares** of funds may charge contingent deferred sales loads or fees when shares are redeemed.

1.10 Unlike an open-end investment company, a closed-end management investment company generally does not offer to redeem its outstanding capital shares on a daily basis. However, some closed-end funds do make periodic **repurchase** offers for their outstanding shares. Those closed-end funds that repurchase their shares on a periodic basis at stated intervals are commonly known as interval funds. The outstanding shares of closed-end funds that are not considered to be interval funds are usually **exchange** listed and traded on the open market at prices that generally differ from net asset value per share, although **market prices** are influenced by net asset value per share reported regularly in financial publications. Most closed-end companies offer their shares to the public in discrete offerings, although some closed-end funds offer their shares on a continuous basis. Closed-end investment companies may offer their shareholders a dividend reinvestment plan. Investments are valued, and net asset value per share is calculated, using the same method as mutual funds.

1.11 Investment companies are classified as **diversified investment companies** or **nondiversified investment companies** (see appendix D, "Worksheet for Diversified Management Investment Companies") and grouped according to their primary investment objectives, for example, income, growth, balanced, money market, or tax-exempt, or combinations of those groups.[7] The kinds of investments made by those funds reflect their stated objectives. For example, growth funds invest almost exclusively in securities with appreciation potential, whereas money market funds invest solely in short-term debt instruments. Shareholder approval is required for an investment company registered as diversified to become nondiversified but not for a company registered as nondiversified to become diversified. If a nondiversified company operates as a diversified company, it may change back to a nondiversified company within three years of the change to a diversified company without shareholder approval, provided that its registration statement has not been amended.

1.12 Closed-end investment companies include venture capital investment companies, such as SBICs and BDCs. A venture capital investment company is a closed-end company whose primary investment objective is capital growth and whose capital is invested at above-average risk to form or develop companies with new ideas, products, or processes. An SBIC is an entity that provides equity capital, long-term loans, or both to small businesses; is licensed by the **Small Business Administration (SBA)** under the **Small Business Investment Company Act of 1958**; and may also be registered under the 1940 Act or be a subsidiary of another company. It may obtain financing from the federal government in the form of subordinated debentures based on the amount of its equity capital and the amount of its funds invested in venture-type investments.

1.13 A UIT is an investment company organized under a trust indenture or similar instrument and registered under the 1940 Act. A UIT has no board of directors and issues only redeemable units, each representing an undivided interest in a group of securities (such as corporate debentures or municipal debt) or in a unit of specified securities or securities of a single issuer (such as shares of a particular mutual fund). UITs that provide a formal method of accumulating mutual fund shares under a **periodic payment plan** or a single payment plan are commonly known as **contractual plans**.

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[7] Section 5(b) of the 1940 Act.

Organizations Providing Services to Investment Companies

1.14 Most mutual funds and many closed-end investment companies have no employees. **Portfolio** management, recording of shares, administration, recordkeeping, distribution, and custodianship are the significant activities required by such funds and companies. These activities generally are performed by organizations other than the investment company, for example, an **investment adviser (manager)**, a **transfer agent**, an administrator, a **recordkeeping agent**, a **principal underwriter** (**distributor**), and a **custodian**. The distributor is often a separate division or subsidiary company of the manager or administrator. The use of agents to perform accounting or other administrative functions does not relieve the investment company's officers and directors of the responsibility for overseeing the maintenance and reliability of accounting records and the fairness of financial reports.

The Manager

1.15 The manager generally provides investment advice, research services, and certain administrative services under a contract, commonly referred to as the investment advisory agreement, that provides for an annual fee, which is often based on a specified percentage of average net assets. The fee schedules of many contracts provide for reduced percentage rates on net assets in excess of specified amounts (**break points**). Other contracts have **performance fee** schedules that provide for a basic fee percentage plus a bonus, or less a penalty, based on a comparison of the fund's performance to a market **index** specified in the investment advisory agreement. If a performance fee schedule is used, the potential bonus for performance better than the index must be matched by an equivalent potential penalty for poor performance;[8] such **incentive fee** arrangements need not be symmetrical if a fund is not registered with the SEC for sale to the general public. Occasionally, the **advisory fee** may be based wholly or partly on the investment income earned by the fund. Administrative services may be provided by an entity other than the manager under a separate administrative agreement.

1.16 The **investment advisory agreement** for a registered investment company must be approved by the initial shareholder (usually the manager) and thereafter by a majority of the directors who are not **interested persons**, as defined by the 1940 Act. Continuation of the contract beyond two years requires annual approval by a vote, cast in person (usually construed to mean face-to-face, not by telephone), of (a) the board of directors or a majority of the outstanding shares and (b) directors who are not interested persons.[9] Significant modifications to the investment advisory agreement after a registered investment company begins its operations would be subject to approval by the board of directors and often are also subject to approval by a vote of a majority of the fund's outstanding shares.

The Distributor

1.17 The distributor, also known as an underwriter of the fund's shares, acts as an agent or a **principal** and sells the fund's shares as a wholesaler through independent dealers or as a retailer through its own sales network. Shares are sold at net asset value, and often a sales charge is added for the underwriter's and dealers' commissions. Other common commission structures

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[8] SEC Release No. 7484 under the 1940 Act.

[9] Sections 2(a)(19), 15(a), and 15(c) of the 1940 Act.

use **rule 12b-1** fees or contingent deferred sales loads. The amount of sales charges, including asset-based sales charges (that is, rule 12b-1 fees) and contingent deferred sales loads, are regulated by the **National Association of Securities Dealers (NASD)**. Additionally, rule 22d-1 of the 1940 Act permits funds to set variable sales charges. A no-load fund may or may not have a distributor.

1.18 Requirements for approval of a distributor's contract by the registered investment company's board of directors are similar to those described for the investment adviser. If the distributor's contract is approved by the board, shareholder approval is not required. Many registered investment companies adopt distribution plans under rule 12b-1 permitting the use of fund assets to pay for distribution expenses. One special requirement of that rule is that members of the board of directors who are not interested persons, as defined, must approve the plan each year and the plan can be terminated with sixty days' notice.

The Custodian

1.19 Custody of the fund's cash and portfolio securities is usually entrusted to a bank or, less frequently, to a member of a national securities exchange that is responsible for their receipt, delivery, and safekeeping. Custody arrangements and the auditor's responsibilities are discussed in detail in chapter 2.

The Transfer Agent

1.20 The fund's transfer agent, which may be a bank or a private company, issues, **transfers**, redeems, and accounts for the fund's capital shares. Sometimes the manager, distributor, or another related party performs those functions. Section 17A of the **Securities Exchange Act of 1934** (the 1934 Act) requires certain transfer agents to register with the SEC and prescribes standards of performance concerning their duties.

The Administrator

1.21 Occasionally the fund may engage an administrator that is independent of the investment adviser. In these instances the administrator would be responsible for performing or overseeing administrative tasks such as the filing of reports with the SEC and the IRS, registering of fund shares, corresponding with shareholders, and determination of the fund's compliance with various restrictions.

Regulation

1.22 Generally, an investment company is required to register with the SEC under the 1940 Act if one of the following is true:[10]

a. Its outstanding securities, other than short-term paper, are beneficially owned by more than 100 persons (including the number of beneficial security holders of a company owning 10 percent or more of the voting securities of the investment company).[11]

b. It is offering or proposing to offer its securities to the public.

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[10] Otherwise, the company is exempted from registration by section 3(c)(1) of the 1940 Act.

[11] Section 3(c)(7) of the 1940 Act allows certain companies to have an unlimited number of qualified investors.

1.23 The Division of Investment Management of the SEC is responsible for reviewing such registrations. The investment company's shares are also registered under the **Securities Act of 1933** (the 1933 Act) and with various state securities commissions before being offered for sale to the public. After registering with the SEC under the 1940 Act or under both the 1933 and 1940 Acts, the company must report periodically to its shareholders and to the SEC. Accordingly, auditors of investment companies should be familiar with the following Acts:

a. The 1933 Act, often referred to as the disclosure act, regulates the contents of **prospectuses** and similar documents and is intended to assure that potential investors receive adequate information to make reasonably informed investment decisions.

b. The 1934 Act regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets. The distributor must register as a broker-dealer under the 1934 Act. The 1934 Act also governs disclosures in **proxy** materials used to solicit the votes of shareholders of an investment company, as does the 1940 Act. If the fund's transfer agent is not a bank, it should be registered under the 1934 Act.

c. The 1940 Act regulates the investment company industry and provides rules and regulations that govern the fiduciary duties and other responsibilities of an investment company's management. Business development companies also register under this Act.

d. The **Investment Advisers Act of 1940** requires persons paid to render investment advice to individuals or institutions, including investment companies, to register, and regulates their conduct and contracts.

e. The Small Business Investment Act of 1958 authorizes the SBA to provide government funds under regulated conditions to small business investment companies licensed under this Act.

f. The **Small Business Incentive Act of 1980** amended the 1940 Act by, among other things, allowing certain closed-end companies to elect to be regulated as business development companies under less rigorous sections 54 through 65 of the 1940 Act.

1.24 The federal securities laws are supplemented by formal rules and regulations; the SEC also issues a variety of other releases and statements, including its financial reporting releases and releases under the 1933, 1934, and 1940 Acts and the Investment Advisers Act of 1940. Many of these rules and regulations apply to the investment company industry. The auditor should be familiar with them and with the SEC registration and reporting forms. The forms illustrate the kind of information that must be made available to the public, the restrictions imposed on operations, the most applicable statutory provisions, and the statistics that should be accumulated and maintained. The forms include the following:

a. Form N-8A, the notification of registration under the 1940 Act, discloses the company's name and address and certain other general information. An investment company is registered under the 1940 Act after it has filed the form, which is brief, and it is then subject to all of the Act's requirements and standards. The information in the form need not be audited.

b. Form N-1A, the registration statement of open-end management investment companies under the 1940 and the 1933 Acts, describes in detail the company's objectives, policies, management, investment restrictions, and similar matters. The initial filing of Form N-1A generally requires audited financial statements, which typically are limited to a "seed capital" statement of assets and liabilities. (Form N-2 is the comparable registration statement for closed-end management investment companies.) When an investment company incurs organization costs that are not paid for and assumed by the fund sponsor, a "seed statement of operations" for the period from the organization date through the date of the statement of assets and liabilities for seed capital is also required. (See chapter 8.) The subsequent filing of post-effective amendments to the registration statement on Form N-1A is discussed in paragraph 1.24.

c. Profile was initiated with the release of rule 498 under the 1933 Act as a means of providing concise, standard information to investors including the fund's investment objectives, strategies, risks, performance, fees, investment adviser and portfolio manager, purchase and redemption procedures, distributions, and services available to the fund's investors. This information would be issued in the form of a "profile" that would provide investors with the ability to invest in a fund or to request additional information concerning a fund. Should an investor choose to invest in a fund from the profile, rule 498 requires that a full prospectus be delivered to the shareholder with the purchase confirmation.

d. Form N-SAR, a reporting form used for semiannual and annual reports by all **registered investment companies** (other than BDCs) registered under the 1940 Act, is divided into four sections, and only certain investment companies need to complete each section. The sections pertain to open-end and closed-end management investment companies, small business investment companies, or unit investment trusts. The report provides current information and demonstrates compliance with the 1940 Act. The annual report filed by a management investment company must be accompanied by a report on the company's internal control over financial reporting from its independent accountant. See chapter 11, paragraph 11.13 for an example of that report.

e. Form N-CSR,[*] adopted in 2003, under which a registered investment company files its annual and semi-annual shareholder reports together with the certifications of principal executive and financial officers required by Rule 30a-2 of the 1940 Act. The Form also provides for disclosure of other information relating to the investment company's code of ethics, audit committee, principal accountant fees and services, internal controls, and (for closed-end funds) proxy-voting policies.

f. Form N-PX, which will become effective in 2004, will report investment companies' proxy voting record for each matter relating to a portfolio security considered at a shareholder meeting held during the twelve-month period ending June 30.

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[*] In December 2002, the SEC proposed adoption of a new Form N-Q which would require the filing of the same schedule of investments required in semi-annual and annual financial statements on a quarterly basis. This form would be signed, but not certified, by the fund's principal financial officer. Comments on the proposal were received through February 14, 2003. See SEC Investment Company Act Release No. 25870 for further information.

g. Form 13F, a quarterly securities inventory of an institutional investment manager (including an investment company) that has either investment discretion or voting power over more than $100 million in listed or *NASD National Market System* (NMS) quoted **equity securities**, is usually filed in composite for an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.

h. Schedule 13G and annual amendments, as of each December 31, to be filed by the following February 14, concern possession of either investment discretion or voting power over more than 5 percent of a class of equity securities of a publicly owned company, provided that the interests were acquired in the ordinary course and not with the purpose or effect of influencing **control**; if the proviso is inapplicable, disclosures of changes in holdings must be made promptly on Schedule 13D. Such reports are usually filed in composite form for an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.

i. Form N-3 is the registration statement for **variable annuity** separate accounts registered as management investment companies under the 1940 Act and the 1933 Act. The form contains information and financial statements similar to the kind required by Form N-1A, and information about the insurance contract and the sponsoring insurance company, including financial statements of the sponsor.

j. Form N-4 is the registration statement for variable annuity separate accounts registered as unit investment trusts under the 1940 Act and the 1933 Act. The form contains information and financial statements similar to the kind required by Form N-1A, and information about the insurance contract and the sponsoring insurance company, including financial statements of the sponsor.

k. Form N-1 is the registration statement for variable life insurance separate accounts registered as management investment companies under the 1940 Act and the 1933 Act.

l. Form N-6 is the form for insurance company separate accounts that are registered as unit investment trusts and that offer variable life insurance policies, replacing the previous combined use of Forms N-8B-2 and S-6. All new registration statements filed on or after December 1, 2002 for such separate accounts must comply with Form N-6. All such separate accounts with currently effective registration statements on Forms N-8B-2 and S-6 must comply with Form N-6 for post-effective amendments that are annual updates to their registration statements filed on or after December 1, 2002 and no later than December 1, 2003.

m. Forms N-8B-2 and S-6 are the forms for all unit investment trusts except those variable annuity and variable life separate accounts registered on Form N-4 and N-6, respectively, under the 1940 Act and the 1933 Act.

n. Form N-5, the registration statement for SBICs, which are also licensed under the Small Business Investment Act of 1958, is a dual-purpose form registering SBICs under both the 1933 Act and the 1940 Act. The form contains the same kind of information and audited financial statements as required by Forms N-1A and N-2 for management investment companies.

o. Form N-14 is the statement for registration of securities issued by investment companies in business combination transactions under the 1933 Act. The form contains information about the companies involved in the transaction, historical financial statements, and pro forma financial statements.

1.25 Information in a currently effective prospectus must be updated for significant events that have occurred since the effective date. Prospectuses of mutual funds offering their shares for sale are updated at least annually. Post-effective amendments on Form N-1A, including updated audited financial statements, must be filed and become effective under the 1933 and 1940 Acts within sixteen months after the end of the period covered by the previous audited financial statements if the fund is to continue offering its shares.

1.26 Registration statements and reports filed by open-end and closed-end companies (other than SBICs) on various forms include financial highlights, usually for the preceding five years, as described in the instructions to Form N-1A, and for the preceding ten years as described in the instructions to Form N-2.

1.27 The form and content of financial statements required in registration statements are governed by **Regulation S-X.** Articles 6 and 12 of Regulation S-X deal specifically with registered investment companies. (SBICs are covered in article 5, but they follow the same value accounting model as do other investment companies.) Registration statements and Form N-SAR are filed using the SEC's EDGAR System.

Financial Reporting to Shareholders

1.28 The 1940 Act and the related rules and regulations specify the financial statements and the timing of reports required to be submitted to shareholders and to the SEC.[12] Reports containing those financial statements must be submitted to shareholders and to the SEC at least semiannually; annual reports must contain audited financial statements. Financial statements included in such reports contain—

- A statement of assets and liabilities and a detailed schedule of investments or a statement of net assets.
- A statement of operations.
- A statement of changes in net assets.

In addition to the basic financial statements, financial highlights (see paragraph 7.1) should be presented either as a separate schedule or within the notes to the financial statements. For an investment company that issues multiple classes of shares, the schedule of financial highlights would need to reflect, at a minimum, the performance of the class of shares that is addressed in the auditor's report. Financial statements for investment companies are discussed and illustrated in chapter 7.

1.29 Funds also may be required to present a statement of cash flows if they do not meet the conditions specified in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale.*[13]

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[12] Rules under section 30(d) of the 1940 Act.

[13] FASB Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*, provides standards as to cash flow reporting.

Accounting Rules and Policies

1.30 Rules under the 1940 Act prescribe the accounting records that an investment company must maintain and the periods for which they must be retained.[14] Those rules require maintenance of journals, general and subsidiary ledgers, and memorandum records, that are subject to examination by representatives of the SEC during periodic and special examinations.

1.31 The accounting policies followed by investment companies result from the companies' role as conduits for the funds of investors interested in investing as a group. Furthermore, the investment company policies are supplemented by the rules and regulations issued under the various acts administered by the SEC and the SBA. Some unique policies are described below and in more detail in the following chapters.

Valuation of Investments

1.32 Values and changes in values of investments held by investment companies are as important to investors as the investment income earned. Investment companies, therefore, report investments at fair value. The fair value of an investment is the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The best evidence of fair value is the quoted market price in an active market. In the absence of a quoted market price, amounts representing estimates of fair values using methods applied consistently and determined in good faith by the board of directors should be used. (See chapter 2 for a more in-depth discussion of the determination of the fair value of investments.)

Effective Date of Transactions

1.33 The established practice in accounting for security purchases and sales, for financial reporting purposes, is to record transactions as of the **trade date**, the date on which the company agrees to purchase or sell the securities, so that the effects of all securities **trades** entered into by or for the account of the investment company to the date of a financial report are included in the financial report.[15] Investment companies record dividend income on the **ex-dividend date**, not on the **declaration, record**, or **payable date**, because on the ex-dividend date the quoted market price of **listed securities** and other market-traded securities tends to be affected by the exclusion of the dividend declared. Also, investment companies record liabilities for **dividends** to shareholders on the ex-dividend or **ex-distribution date**, not on the declaration date as other corporations do, because mutual fund shares are purchased and redeemed at prices equal to or based on net asset value. Investors purchasing shares between the declaration and ex-dividend dates are entitled to receive the dividend, whereas investors purchasing shares on or after the ex-dividend date are not entitled to the dividend.

Other Rules

1.34 The 1934 Act specifies the records that must be maintained by the principal underwriter for the fund, the period for which the records must be

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[14] Rules under section 31 of the 1940 Act.

[15] Rule 2a-4 of the 1940 Act permits registered investment companies to record security transactions as of one day after the trade date for purposes of determining net asset value. However, for financial reporting purposes, security transactions should be recorded on the trade date.

preserved, and the reports that the principal underwriter must file with the SEC.[16] The records are subject to examination by representatives of the SEC. Once during each calendar year, each principal underwriter is required (as are other **brokers** and dealers) to file audited financial statements. The AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* provides additional discussion.

1.35 The 1940 Act specifies the kind of notice to shareholders that should accompany **distributions** from sources other than accumulated undistributed income, describing the source of such distributions.[17] That notice must indicate clearly the portion of the payment (per share of outstanding capital stock) made from net investment income or accumulated undistributed net investment income, realized gains, and accumulated undistributed net realized gains on the sales of securities and capital.

1.36 Section 32(a) of the 1940 Act requires that the independent auditor reporting on financial statements of an investment company be selected annually by a majority of directors who are not interested persons at a meeting held no more than thirty days before or after the commencement of the investment company's fiscal year or before the annual meeting of stockholders in that year. Additionally, if the investment company is organized in a jurisdiction that does not require annual shareholder meetings and the investment company does not hold a meeting in a given year and is part of a complex of related investment companies that do not share a common fiscal year, the independent auditor may be selected by the directors at a meeting held either within thirty days before or within the first ninety days after the commencement of that company's fiscal year. The directors' selection must be submitted to the stockholders for ratification during any year in which an annual meeting of stockholders is held, unless the appointment of the auditors is approved by an Audit Committee composed solely of independent directors and the Audit Committee maintains a charter which is maintained in an easy accessible place.[18] The employment of the accountant is conditioned upon the right of the investment company to terminate such employment without any penalty by a vote of the outstanding shares of the investment company. If the independent auditor resigns or is unable to carry out the engagement, the disinterested directors may appoint a successor.[19]

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16 Rules 17a-4 and 17a-5 of the Securities Exchange Act of 1934.

17 Section 19 and rule 19a-1 of the 1940 Act.

18 Rule 32a-4 under the Investment Company Act of 1940.

19 Section 32(a) and rule 32a-3 of the 1940 Act.

Chapter 2

Investment Accounts

2.01 An investment company's securities portfolio typically comprises substantially all its net assets. Portfolio securities produce income from dividends, interest, and changes in fair values of securities while they are owned by the fund.

Investment Objectives and Policies

2.02 The composition of an investment company's portfolio is primarily a function of the company's investment objectives and strategy to achieve them. An investment company discloses the investment objectives adopted by its management and the strategies adopted to achieve them in its charter or partnership agreement and in documents such as registration statements, prospectuses, or offering circulars. Restrictions, statutory or otherwise, are also disclosed. Those restrictions may include specific limitations or outright prohibitions of transactions in real estate, commodities or commodity contracts, and property other than securities. Other restrictions may include limitations on investing in **unregistered securities**, making **short sales** of securities, **underwriting** securities of other issuers, acquiring securities of other investment companies, or using leveraging techniques, such as **margin accounts**, bank borrowing, and transactions in options and futures.

2.03 An investment company may also specify the kinds of securities, such as bonds, preferred stocks, **convertible securities**, common stocks, **warrants**, or options, in which it may or must invest and the proportion of its total assets that may be or must be invested in each kind of security. Specific limitations relate to the following:

- The percentage of the investment company's assets it may invest in the securities of an issuer or in issuers of a specific country, geographic region, or industry
- The percentage of voting securities of an issuer it may acquire
- Investments in companies for the purpose of control
- The risk profile of the portfolio: for example, restrictions on the allocation of assets between domestic and foreign securities, the percentage of assets invested in **illiquid** or emerging market securities, or the level of investment in derivative instruments

Operations and Controls

Recordkeeping Requirements

2.04 The Investment Company Act of 1940 (the 1940 Act) prescribes minimum accounting records for registered investment companies.[1] The required investment records for all registered investment companies include—

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[1] Section 31 of the Investment Company Act of 1940 (the 1940 Act) and rules under that section.

- Journals or other records of original entry that show all securities purchases and sales, receipts and deliveries of securities, and collections and payments of cash for securities transactions
- A securities record or ledger showing the unit, quantity, price, and aggregate cost separately for each portfolio item and for each transaction, as of the trade date
- A record for each portfolio item of all trading orders for purchase or sale by or on behalf of the investment company and the action on each order

The books and records of registered investment companies are subject to retention and inspection requirements set forth in rules under the 1940 Act.[2]

2.05 If any records required by the rules are maintained by an agent, such as a custodian or transfer agent, the registered investment company should obtain the agent's written agreement to make the records available on request and to preserve them for the required periods.

Custody of Securities

2.06 An investment company's securities are usually held in the custody of a bank, which, for registered investment companies, must have prescribed minimum aggregate capital, surplus, and undivided profits.[3] A member firm of a national securities exchange or a central securities system registered with the Securities and Exchange Commission (SEC) also may serve as custodian. To use a member of a national securities exchange as custodian, a registered investment company must initially obtain the approval of a majority of its board of directors. The 1940 Act and the related rules require that securities held in custody by a member of a national securities exchange be inspected at various times by the registered investment company's auditor and that the auditor issue a report thereon to the SEC.[4] Investment companies may also enter into subcustodial agreements, usually to provide a local custody function for investment in foreign securities. The nature of these agreements can vary as to whether the principal custodian does or does not assume responsibility for the subcustodian's actions. (See also the discussion in paragraph 2.97 relating to foreign custodian arrangements and in paragraphs 2.145 through 2.147 relating to the auditor's procedures with respect to custodians.)

2.07 Registered investment companies are required to file copies of their custodial agreements with the SEC. Significant provisions of such agreements deal with—

- Physical and book segregation of securities in custody.
- Denying custodians the power to assign, **hypothecate**, pledge, or otherwise encumber or dispose of any securities except in acting at the direction and for the account of the registered investment company.
- Immunity of such securities to liens asserted by a custodian.
- The right of the SEC and the company's independent auditors to inspect the securities at any time.[5]

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2 Rules 31a-2, 31a-3, and section 31b of the 1940 Act.

3 Sections 2(a)(5), 17(f) and 26(a) of the 1940 Act.

4 Rule 17f-1 of the 1940 Act.

5 Section 17(f) of the 1940 Act.

2.08 An investment company may retain custody of its securities by depositing them for safekeeping in a vault or other depository maintained by a bank or a company whose functions and physical facilities are supervised by federal or state authorities. The 1940 Act and the related rules require all securities determined to be held in safekeeping, either by a registered investment company or an affiliated bank as a custodian, to be inspected at various times by the registered investment company's independent auditor.[6] The deposited securities are required to be physically segregated and subject to withdrawal only by duly authorized persons under specified conditions.

Accounting for Segregated Accounts

2.09 Certain investment transactions may involve a registered investment company's issuance of a "senior security" as defined under section 18 of the 1940 Act. Section 18 also contains restrictions on the issuance of senior securities. Generally, a senior security represents an indebtedness of the investment company (for example, leverage), including certain transactions under which the investment company enters into a contractual purchase or delivery obligation (for example, futures and written options on securities). The SEC does not raise the issue of compliance with section 18 with respect to certain transactions, however, if a registered investment company designates certain assets in a segregated account, either with the custodian or in its accounting records, as "cover" for indebtedness. Such assets consist of cash, or securities as permitted by the SEC (that is, which meet the **liquidity** guidelines specified by the SEC), and they may be replaced only by other similar assets.[7] Securities maintained in such segregated accounts should be valued using an appropriate methodology for those securities.[8] The determination of whether a senior security has been issued, or whether a senior security has been adequately covered, is at times complex and may require the involvement of legal counsel.

2.10 An investment company using a bank or a member of a national securities exchange as custodian of its securities may agree to have qualifying securities deposited in a **clearing agency**, such as a central securities system, that is registered with the SEC. Clearing agencies use the **book entry shares** method of accounting for securities transfers rather than methods based on the physical movement of the securities. Most investment companies' portfolio securities that qualify are now held by clearing agencies (such as The Depository Trust Company) through arrangements with the investment companies' custodians, instead of being held by the custodians in physically issued form. Investment companies or their custodians may also use the Federal Reserve's book entry system as a depository for U.S. and federal agency securities. Special rules apply to the use of central securities systems and book entry systems.[9]

2.11 If a registered investment company uses a bank as custodian for its securities, the proceeds from sales of such securities and other cash assets, except for minor amounts in checking or petty cash accounts approved by the board of directors, are required to be kept in the bank's custody.[10] SEC reg-

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[6] Rule 17f-2 of the 1940 Act.

[7] See Securities and Exchange Commission (SEC) Release No. 10666 under the 1940 Act, as modified by a no-action letter to Merrill Lynch Asset Management, L.P., July 2, 1996, and a letter of SEC Division of Investment Management Chief Accountant to Investment Company Chief Financial Officers, November 7, 1997.

[8] SEC Release No. 10666 under the 1940 Act.

[9] Rule 17f-4 of the 1940 Act. In February of 2003 the SEC amended Rule 17f-4 to simplify custodial requirements for mutual funds. See SEC Release No. IC-25934 for more information.

[10] Release Nos. 6863 and 7164 under the 1940 Act.

ulations also permit the maintenance of cash balances with futures commission merchants solely for the purpose of clearing daily activity in futures contracts and related options.[11]

Routine Investment Procedures

2.12 Although the overall direction of the investment activities of an investment company is the responsibility of its board of directors, the board typically delegates the routine operating and investment decisions to an investment committee, a portfolio manager, or, as in most situations, an investment adviser. Investment decisions are communicated by the investment company's adviser or the adviser's employees who place orders with brokers. An investment company's registration statement or offering circular indicates its policies on selecting brokers and on using affiliates to execute trades. A well-designed system of controls for investment transactions would include the procedures described in the following paragraphs.

2.13 A registered investment company is required by rule 31a-1 of the 1940 Act to document, among other things, the placement of a securities order in an internal record that shows the person who authorized and placed the order, the security, the number of shares or the principal amount ordered, the price or price range, the date and time the order was entered and executed, the commission rate or amount (or other compensation paid), the broker selected, and the reason for the selection. Executed transactions are routinely confirmed electronically or by telephone, and confirmations are followed by electronic or written advices containing all information pertinent to the trades. The advices for money market instruments ordered through a bank often consist of bank debit or credit memorandums.

2.14 An investment company should notify the custodian promptly of each securities transaction and issue detailed instructions to receive or deliver securities and to collect or disburse cash. Those instructions should include the name of the broker, the description and quantity of the security, the trade and **settlement dates**, and the net amount of cash to be collected or disbursed. New York Stock Exchange rule 387 requires the electronic depository confirmation-affirmation system (also known as Broker ID System) to be used to effect securities transactions on a cash on delivery (COD) or delivery versus payment (**DVP**) basis. The instructions should be signed by one or more authorized representatives of the investment company whose signatures are on file with the custodian; if instructions are given by telephone or electronically, procedures should be established to ensure proper authorization.

2.15 As advices confirming trades are received, they should be reviewed promptly for conformity of terms, clerical accuracy, and proper application of commission rates, including volume discounts or negotiated rates, as applicable, and should be compared with the internal records established when the orders were placed.

2.16 Investment companies almost always require receipt of cash for securities delivered by the custodian to settle sales of portfolio investments. Similarly, the custodian pays on a DVP basis. In certain countries, however, there is no DVP requirement. Unless otherwise instructed, the custodian rejects a transaction if either the number of shares or the settlement amount determined by the broker does not agree exactly with the written instructions authorized previously by the investment company.

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[11] Rule 17f-6 under the 1940 Act.

2.17 The custodian notifies the investment company promptly of cash settlements and receipts or deliveries of securities. Settlement dates vary, based on the kind of security traded, from same day settlement to four weeks or more. On receipt of such notifications, the investment company should compare them against its records to identify discrepancies. **Fails to receive** or **fails to deliver** should be identified on the settlement date and followed up promptly.

2.18 The custodian issues periodic statements listing all receipts and deliveries of securities and related collections and disbursements of cash. Securities on hand and the cash balance at the end of the period may be shown following the chronological list of transactions. An investment company should reconcile promptly the custodian's statements with its books and records and should initiate timely follow-up procedures on reconciling items. The investment company should be satisfied with the adequacy of the custodian's procedures and controls that relate to functions carried out on its behalf, especially procedures and controls for receipt, delivery, and safekeeping of securities.

Accounting

Net Asset Value Per Share

2.19 Virtually all open-end investment companies and many closed-end investment companies prepare daily **price make-up sheets** computing net asset value per share each day the New York Stock Exchange (**NYSE**) conducts trading activity. Rule 22c-1(b) of the 1940 Act establishes customary U.S. business days as the days on which an open-end investment company, at a minimum, must price its redeemable securities, provided customer orders have been received and significant price changes in the fund's portfolio securities or other activities or transactions affecting the per share net asset value of the fund exist. Closed-end companies may compute net asset value per share less frequently, such as weekly or semimonthly.

2.20 Net asset values per share should reflect portfolio securities at fair value. Securities should be valued at least as often as net asset value per share is computed or shares are issued or redeemed. Registered investment companies value their portfolios at such time of day and at such frequency as is determined by their boards of directors.[12]

2.21 Changes in security positions should be reflected in the net asset value per share computations no later than the first calculation following the trade date.[13] Similarly, changes in the number of the investment company's outstanding shares from sales, distributions, and repurchases should be reflected in the computations no later than the first calculation following such changes.

2.22 Because of the importance of net asset value per share, many investment companies perform additional procedures to make sure of the accuracy of security valuations. The fair value assigned to each security position may be compared with the fair value used on the preceding valuation date to detect increases or decreases in specific security values that are unusual or that exceed predetermined amounts or percentages. In addition, unchanged security values may be reviewed to determine whether this valuation continues to be appropriate. It is advisable to review and explain such increases, decreases, or unchanged prices.

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[12] Rule 22c-1(b) of the 1940 Act.

[13] Rule 2a-4(b) of the 1940 Act. Also see footnote 15, chapter 1.

2.23 Net asset value per share should also reflect expenses, interest, and other income through the date of the calculation.[14] The 1940 Act does not require expenses, income items, or both to be accrued daily if their net cumulative amount is less than one cent per outstanding share.[15] Other aspects of accrual accounting specific to investment companies, discussed in this chapter and other chapters of the Guide, should also be considered.

2.24 Mutual funds with multiple classes of stock must determine the net assets and net asset value per share for each class in accordance with the procedures enumerated by rule 18f-3 of the 1940 Act (or in accordance with an exemptive order issued by the SEC). See chapter 5 for additional information on multiple-class funds.

Basis of Recording Securities Transactions

2.25 As indicated previously, accepted practice in the investment company industry is to record securities transactions as of the trade date rather than the settlement date. For that reason, the statement of assets and liabilities of most investment companies at the end of an accounting period includes receivables from brokers for securities sold but not delivered and payables to brokers for securities purchased but not received.

2.26 A securities transaction outside conventional channels, such as through a **private placement** or by submitting shares in a **tender offer**, should be recorded as of the date the investment company obtained a right to demand the securities purchased or to collect the proceeds of sale, and incurred an obligation to pay the price of the securities purchased or to deliver the securities sold, respectively. Determining the recording date may sometimes require an interpretation by legal counsel.[16]

2.27 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides accounting and reporting standards that are applicable to investment companies' transactions such as **repurchase** and **reverse repurchase agreements**, **dollar rolls**, and securities borrowed and loaned.

Methods of Valuing Investments

2.28 Investment companies report their investments (for example, securities and derivatives) at fair value, which is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.[17] Many financial instruments are traded publicly in active markets, and therefore end-of-day market quotations are readily available. Quoted market prices in active markets are the best evidence of the fair value of a financial instrument. If quoted market prices in active markets are not available, fair value may be estimated in a variety of ways depending on the nature of the instrument and

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[14] See note 13.

[15] Rule 2a-4(b) of the 1940 Act.

[16] SEC, *Codification of Financial Reporting Policies*, section 404.03.a.

[17] This definition is roughly equivalent to the definition of "value" appearing in section 2(a)(41) of the 1940 Act, as further interpreted in SEC, *Codification of Financial Reporting Policies*, section 404.03.

the manner in which it is traded.[18] Management's best estimate in good faith (under the direction of the board of directors) of fair value should be based on the consistent application of a variety of factors in accordance with the valuation policy followed by the fund with the objective being to determine the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The fair value reported for investments is not reduced by estimated brokerage commissions and other costs that would be incurred in selling the investments.

2.29 An investment company's registration statement or offering circular describes the methods used to value its investments.[19] Section 404.03 of the SEC's *Codification of Financial Reporting Policies* describes various methods for estimating fair value. Those methods are discussed in this section (see paragraphs 2.34 through 2.38).

2.30 Valuing *Market-Traded Securities.* Valuing securities listed and traded on one or more securities exchanges, or **unlisted securities** traded regularly in **over-the-counter (OTC)** markets (for example, U.S. Treasury bonds, notes and bills or stocks traded in the National Market System [NMS] of the **NASDAQ** Stock Market), ordinarily is not difficult, because quotations of completed transactions are published daily, or price quotations are readily obtainable from financial reporting services or individual broker-dealers. A security traded in an active market on the valuation date is valued at the last quoted sales price except in rare situations (see paragraph 2.33 for examples of those situations).[20] A security listed on more than one national securities exchange should be valued at the last quoted sales price at the time of valuation on the exchange on which the security is principally traded; securities traded both on a national exchange and in the over-the-counter market should be valued based on the price in the market in which the security is principally traded. If the security was not traded in the principal market on the valuation date, the security should be valued at the last quoted sales price on

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[18] Section 2(a)(41) of the 1940 Act.

[19] Instructions to Form N-1A (revised effective June 1, 1998), item 7(a)(1).

[20] During the clearance procedures for this Guide, the FASB expressed concern that an entity's ability to use a blockage factor to estimate an unrestricted investment's fair value when that investment has a quoted market price in an active market is unclear based on the guidance in paragraphs 2.30–2.36, paragraph 2.38, and paragraph 2.71 of this Guide. The FASB observed that the definition of fair value as used in FASB Statements No. 107, *Disclosures about Fair Value of Financial Instruments*, No.115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 133, *Accounting for Derivative Instruments and Hedging Activities*, prohibits the use of a blockage factor in estimating an investment's fair value if a quoted market price is available. The FASB also has issued Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*. Paragraph 70 of the Preliminary Views states:

One of the fundamental objectives in this Preliminary Views is to base fair value on market prices if they are available. Adjusting observed prices for estimated control premiums or blockage factors would conflict with that objective.

The FASB understands that there is diversity in current practice among those entities subject to this Guide regarding whether and when a blockage factor is applied in estimating the fair value of an unrestricted investment that has a quoted market price in an active market and how that factor is measured. As a result of that diversity, FASB will address the issue if it is ever appropriate to use a blockage factor to estimate the fair value of an unrestricted investment with a quoted market price in an active market in its *Disclosures about Fair Value* project. The project also will consider guidelines on how such a factor, if applied, would be measured. Until that project is finalized, if it was the entity's accounting policy in investment company financial statements issued for fiscal years ending on or before May 31, 2000, to apply a blockage factor to estimate the fair value of certain unrestricted investments that have a quoted market price in an active market, the entity may continue to apply that policy to those and similar investments and should make the disclosures required by paragraph 2.38. Otherwise, an entity may not elect to adopt such a policy pending completion of the FASB's project on measuring financial instruments at fair value. FASB plans to issue an Exposure Draft in the fourth quarter of 2003.

the next most active market, if management determines that price to be representative of fair value. If the price is determined not to be representative of fair value, the security should be valued based on quotations readily available from principal-to-principal markets, financial publications, or recognized pricing services (see paragraphs 2.31 and 2.32), or a good-faith estimate of fair value should be made (see paragraphs 2.34 through 2.38).

2.31 Securities markets, financial publications, and recognized pricing services frequently provide quotations of **bid price** and **asked price**. Those quotations may be used if a principal-to-principal market is the primary market for the security on the valuation date, or in the absence of trading on the valuation date of the security normally traded primarily on an exchange. Some investment companies use the bid price to value all securities, some use the mean between the bid and asked prices, and some use a valuation within the range between bid and asked prices considered to best represent fair value in the circumstances. If price quotations are obtained from individual broker-dealers making a market in the security, some investment companies will estimate fair value as the mean of the quoted prices obtained. Each of those policies is acceptable if applied consistently in accordance with the investment company's established pricing policy. Neither use of the asked price alone to value investments, nor use of the bid price alone to value short sales or **short** positions, is acceptable. If only a bid price or an asked price is available for a security on the valuation date, or the **spread** between the bid and asked price on that date is substantial, quotations for several days should be reviewed in determining whether the last quoted price is representative of fair value.

2.32 Many funds utilize pricing services to obtain security valuations. Those pricing services may include quotations on listed securities and OTC securities as described in the preceding paragraphs. Also, particularly for debt securities, pricing services may provide valuations determined by other pricing techniques. Methods generally recognized in the valuation of financial instruments include analogy to reliable quotations of similar financial instruments, pricing models, **matrix pricing**, or other formula-based pricing methods. Those methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as matrix pricing may be used to determine fair value based on market data available with respect to the issue and similar issues without exclusive reliance on issuer-specific quoted market prices.

2.33 Situations may arise when quoted market prices are not readily available or when market quotations are available but it is questionable whether they represent fair value. Examples include instances when—

- Market quotations and transactions are infrequent and the most recent quotations and transactions occurred substantially prior to the valuation date.
- The market for the security is "thin" (that is, there are few transactions or market-makers in the security, the spread between the bid and asked prices is large, and price quotations vary substantially either over time or among individual market-makers).
- The last quoted market prices for foreign securities are as of the close of a market, which precedes the fund's normal time for valuation, and certain events have taken place since the close of that foreign market which provide evidence that the market prices of those securities would be substantially different at the fund's normal time for valuation if such foreign market were open at that time.

- Trading in a market, or for a specific security, had been suspended during a trading day and had not reopened by the fund's normal time for valuation, for such reasons as the declaration of a market emergency by a regulatory body, the imposition of daily price change limits or "circuit-breakers," or the intended release of information by an issuer expected to have a material effect on a security's value.

Similar circumstances may also affect the appropriateness of valuations supplied by pricing services. Situations such as those above are expected to be rare but may occur. In those cases, an investment company may establish a policy to substitute a good-faith estimate of fair value for the quoted market price or pricing service valuation. Any policy adopted should be consistently applied in all situations where significant pricing differences are determined to exist.

2.34 *Estimating Fair Values of Investments.* The SEC's *Codification of Financial Reporting Policies* provides guidance on the factors to be considered in, and on the responsibilities for and methods used for, the valuation of securities for which market quotations are not readily available.[21] The following paragraphs regarding securities valued in good faith are consistent with those SEC policies and are intended to summarize and provide guidance on this topic.

2.35 The objective of the estimating procedures is to state the securities at the amount at which they could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The term current transaction means realization in an orderly disposition over a reasonable period. All relevant factors should be considered in selecting the method of estimating in good faith the fair value of each kind of security.

2.36 In estimating in good faith the fair value of a particular financial instrument, the board or its designee (the valuation committee) should, to the extent necessary, take into consideration all indications of fair value that are available. This Guide does not purport to delineate all factors that may be considered; however, the following is a list of some of the factors to be considered:[22]

- Financial standing of the issuer
- Business and financial plan of the issuer and comparison of actual results with the plan
- Cost at date of purchase
- Size of position held and the liquidity of the market
- Contractual restrictions on disposition
- Pending public offering with respect to the financial instrument
- Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings, and conversions)
- Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable companies
- Ability of the issuer to obtain needed financing
- Changes in the economic conditions affecting the issuer

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[21] SEC, *Codification of Financial Reporting Policies*, sections 404.03 and 404.04.

[22] The SEC's *Codification of Financial Reporting Policies* provides guidance on the factors to be considered, and on the methods used to value securities for which market quotations are not readily available.

- A recent purchase or sale of a security of the company
- Pricing by other dealers in similar securities
- Financial statements of investees

2.37 No single method exists for estimating fair value in good faith because fair value depends on the facts and circumstances of each individual case. Valuation methods may be based on a multiple of earnings, or a discount or premium from market, of a similar, freely traded security of the same issuer; on a **yield to maturity** with respect to debt issues; or on a combination of these and other methods. In addition, with respect to derivative products, other factors (such as volatility, interest and foreign exchange rates, and term to maturity) should be considered. The board of directors should be satisfied, however, that the method used to estimate fair value in good faith is reasonable and appropriate and that the resulting valuation is representative of fair value.

2.38 The information considered and the basis for the valuation decision should be documented, and the supporting data should be retained.[23] The board may appoint individuals to assist it in the estimation process and to make the necessary calculations. (See also the discussion in paragraphs 2.164 through 2.178 relating to the auditor's responsibilities with regard to the valuation of securities.) The rationale for the use of a good-faith estimate of fair value different from market quotations or pricing service valuations should be documented. If considered material, the circumstances surrounding the substitution of good-faith estimates of fair value for market quotations or pricing service valuations should be disclosed in the notes to the financial statements. That disclosure should include the circumstances surrounding the use of a blockage factor for an unrestricted investment that has a quoted market price in an active market.[24]

2.39 *Money Market Funds.* As set forth in **rule 2a-7** under the 1940 Act, a money market fund may value securities using the amortized cost[25] or **penny-rounding method** subject to certain determinations by its board of directors. Rule 2a-7 requires, among other things, that a money market fund's board of directors "establish procedures reasonably designed . . . to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase at a single value." Rule 2a-7 sets forth procedures that must be adopted by the board of directors when using the **amortized cost** or penny-rounding method of valuation. Additionally, for funds using the amortized cost method, the board of directors should perform a periodic review of both the monitoring of and the extent of any deviation from fair value and the methods used to calculate the deviations.

Determining Costs and Realized Gains and Losses

2.40 The cost of investment securities held in the portfolio of a registered investment company and the net **realized gains or losses** thereon are determined, for financial accounting purposes, on the specific identification or

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[23] SEC, *Codification of Financial Reporting Policies*, sections 404.03 and 404.04.

[24] See footnote 20 and the Notice to Readers for further discussion about the use of a blockage factor.

[25] A money market fund using the amortized cost method (*a*) may not purchase securities with a remaining maturity (as the term is defined in rule 2a-7) greater than thirteen months (exclusive of certain U.S. government securities), (*b*) must maintain a weighted average maturity of ninety days or less, and (*c*) may not have a deviation of greater than one-half of 1 percent between the net asset value of the fund valued at fair value and amortized cost.

average-cost methods.[26] An investment company should use only one method for all securities. Cost includes commissions and other charges that are a part of securities purchase transactions. The average-cost method of computing gains and losses may not presently be used for federal income tax purposes.

2.41 An investment company occasionally may be entitled to receive awards from litigation relating to an investment security. Awards should be recorded in accordance with the gain contingency provisions of FASB Statement No. 5, *Accounting for Contingencies*, considering such factors as the enforceability of the right to settlement and the ability to determine the amount receivable. If the investment company holds the securities, the award is accounted for as a reduction of cost. If the investment company no longer holds the securities, the proceeds should be accounted for as realized gains on security transactions.

2.42 An investment company may receive securities in a spin-off wherein the company in which the investment company has invested spins off a portion of its operations. Spin-offs are usually tax-free reorganizations, and no gain or loss is recognized for income tax or financial reporting purposes. A portion of the cost of the securities held is allocated to the securities received in the spin-off. That amount is based usually on the ratio of the fair value of the securities received to the sum of the fair value of such securities and the fair value of the original securities held by the investment company of the company effecting the spin-off.

2.43 From time to time, tender offers may be received for securities held by an investment company. The terms of the offer may be for cash, debentures of the acquiring company, stock of the acquiring company, or a combination thereof. Even if the investment company tenders its securities, it should continue to value the shares tendered until the number of shares accepted in the tender is known. Thereafter, the investment company should value the assets to be received for the shares tendered.

2.44 Accrued interest on bonds bought between interest dates is accounted for as a receivable. Accrued interest on bonds sold is accounted for as a reduction of accrued interest receivable and is not a factor in determining gain or loss on a sale.

Accounting for Investment Income

2.45 An investment company's investment income consists primarily of dividends and interest.

2.46 *Dividends.* Dividends on investment securities are recorded on the ex-dividend date. Distributions that represent **returns of capital** are credited to investment cost rather than to investment income.

2.47 **Stock splits** and **stock dividends** in shares of the same class as the shares owned are not income to the investment company. However, dividends for which the recipient has the choice to receive cash or stock are usually recognized as investment income in the amount of the cash option, because in such cases cash is usually the best evidence of fair value of the stock.

2.48 Other noncash dividends are recognized as investment income at the fair value of the property received.

2.49 Stock rights (that is, subscription rights) received are allocated a prorated portion of the cost basis of the related investment; however, investment

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[26] Rule 2a-2 of the 1940 Act.

companies usually follow tax accounting, which does not require allocation if the fair value of the rights is 15 percent or less of the fair value of the investment company's holdings.[27]

2.50 Cash dividends declared on stocks for which the securities portfolio reflects a short position as of the record date should be recognized as an expense on the ex-dividend date.

2.51 As a routine operating policy, investment companies should consult reliable published or other sources for daily dividend declarations and other **corporate actions** to be sure they obtain and record relevant dividend information in a timely manner. Investment companies should have procedures that provide for follow-up and for disposition of dividends not collected in the regular course of business because of delays in settling securities transactions or completing transfer procedures.

2.52 *Interest.* Interest income on debt securities, such as **corporate bonds,** municipal bonds, or treasury bonds, is accrued daily. Premiums and discounts should be amortized using the **interest method.**[28] Paydown gains and losses on mortgage- and asset-backed securities should also be presented as an adjustment to interest income. **Amortization** of **bond premiums** and **bond discounts** for federal income tax purposes is discussed in chapter 6. **Original issue discount** (OID) on bonds and other debt securities is required to be amortized for tax and financial reporting purposes. Discounts on the purchase of bonds that do not provide for periodic interest payments, sometimes called **zero coupon bonds**, should be amortized to income by the interest method.

2.53 An investment company should consider collectibility of interest in making accruals.

2.54 Interest received on bonds that were in default or that were delinquent in the payment of interest when acquired should be accounted for as follows: (*a*) the amount of interest earned from the date of acquisition of the bond through the current period should be recorded as interest income and (*b*) the amount of interest in arrears at the date of acquisition of the bond should be recorded as a reduction of the cost of the investment.[29]

2.55 The accrued interest receivable account should be analyzed at regular intervals to make sure that interest payments due are received promptly and in the correct amount. Similarly, the disposition of purchased interest receivable and interest accruals on debt securities sold between interest dates should be analyzed periodically.

Defaulted Debt Securities

2.56 In accordance with the guidance provided by FASB Statement No. 5, accrued interest should be written off when it becomes probable that the interest will not be collected and the amount of uncollectible interest can be reasonably estimated.

2.57 The portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of

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[27] Section 307 of the Internal Revenue Code.

[28] As stated in paragraph 18 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, the objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment (that is, the principal amount of the investment adjusted by unamortized fees or costs and purchase premium or discount).

[29] SEC, *Codification of Financial Reporting Policies*, section 404.02.

interest income. Write-offs of purchased interest should be reported as increases to the cost basis of the security, which will result in an unrealized loss.

Accounting for Expenditures in Support of Defaulted Debt Securities

2.58 When issuers of debt securities default, the bondholders often become active in any negotiations and in the workout process. This process often results in new terms that restructure the obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the holders of the obligations.

2.59 Adverse economic developments often lead to increases in the default rates of debt securities. In addition to occasional capital infusions, professional fees to legally restructure the investments are frequently incurred by the bondholders.

2.60 *Capital Infusions.* Capital infusions are expenditures made directly to the issuer to ensure that operations are completed, thereby allowing the issuer to generate cash flows to service the debt. Such expenditures are usually nonrecurring. In certain cases, bondholders may receive additional promissory notes, or the original bond instrument may be amended to provide for repayment of the capital infusions. All capital infusions in support of defaulted securities should be recorded as an addition to the cost basis of the related security (which will result in an unrealized loss) because the nature of capital infusions is to enhance or prevent substantial diminution in the fair value of the investment.

2.61 *Workout Expenditures.* Workout expenditures consist of professional fees (legal, accounting, appraisal) paid to entities unaffiliated with the investment company's advisor or sponsor in connection with (*a*) capital infusions, (*b*) restructurings or plans of reorganization, (*c*) ongoing efforts to protect or enhance an investment, or (*d*) the pursuit of other claims or legal actions. Workout expenditures that are incurred as part of negotiations of the terms and requirements of capital infusions, or that are expected to result in the restructuring of or a plan of reorganization for an investment, should be recorded as realized losses. Ongoing expenditures to protect or enhance an investment, or expenditures incurred to pursue other claims or legal actions, should be treated as operating expenses.

Lending of Portfolio Securities

2.62 Investment companies may lend securities (principally to broker-dealers). Such transactions are documented as loans of securities in which the borrower of securities generally is required to provide collateral to the lender, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities normally earns a return by investing that cash, typically in short-term high-quality debt instruments, at rates higher than the rate paid or rebated to the borrower. Investment of cash collateral is subject to the investment company's investment restrictions. If the collateral is other than cash, the lender of securities typically receives a fee. The investment company, as lender, receives amounts from the borrower equivalent to dividends and interest on the securities loaned. As with other extensions of credit, there are risks of delay in recovery or even loss of rights in the collateral should the borrower of the securities fail financially.

2.63 Under FASB Statement No. 140 cash (or other securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted. See paragraph 15 of FASB Statement No. 140 for accounting guidance. As stated in footnote 4 to paragraph 15 of FASB Statement No. 140, cash collateral shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing. Investment company securities lending transactions often entitle and obligate the transferor to repurchase or redeem the transferred assets before their maturity and the transferor, accordingly, maintains effective control over those assets. Those transactions shall be accounted for as secured borrowings.

Accounting for Derivatives

2.64 FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,*[*] establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (referred to collectively as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be designated specifically as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (*b*) a hedge of the exposure to variable cash flows of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign currency denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 (paragraphs 44 through 47) also contains extensive disclosure requirements. Readers should refer to the full text of the Statement and related amendments when considering accounting and reporting issues related to derivative instruments and hedging activities. The FASB established a Derivatives Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site http://www.fasb.org. SAS No. 92, *Auditing Derivative Instruments, Hedging*

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[*] On April 30, 2003, the FASB issued FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The Statement amends FASB Statement No. 133 for decisions made: (1) as part of the Derivatives Implementation Group process that effectively required amendments to FASB Statement No. 133, (2) in connection with other FASB projects dealing with financial instruments, and (3) in connection with implementation issues raised in relation to the application of the definition of a derivative, in particular, the meaning of *an initial net investment that is smaller than what would be required for other types of contracts that would be expected to have a similar response to changes in market factors,* the meaning of *underlying*, and the characteristics of a derivative that contains financing components. This Statement is effective for contracts entered into or modified after June 30, 2003, with certain exceptions as described in FASB Statement No. 149, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. Readers should consider the requirements of FASB Statement No. 149 in addition to the guidance contained in FASB Statement No. 133, as amended, and this Guide.

Activities, and Investments in Securities, provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, investments in debt and equity securities, and investments accounted for under APB Opinion No. 18. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing SAS No. 92.

Accounting for Foreign Investments

2.65 Investments in securities of foreign issuers involve considerations not typically associated with domestic investments. Foreign securities are denominated and pay distributions in foreign currencies, exposing investment companies to changes in foreign currency exchange rates. Investments in certain foreign countries may include the risk of expropriation or confiscatory taxation, limitations on the removal of funds or other assets, political or social instability, or adverse diplomatic developments. Individual foreign economies may differ from the economy of the United States in growth of gross domestic products, rates of inflation, capital reinvestments, resource self-sufficiency, and balance of payments positions. Securities of many foreign companies may be less liquid and their prices more volatile.

2.66 Because most foreign securities are not registered with the SEC, most of their issuers are not subject to the SEC's reporting requirements. Usually there is less government supervision and regulation of stock exchanges, brokers, and companies in foreign countries than in the United States. As a result, financial or regulatory information concerning certain foreign issuers of securities may not be as readily available. Also, foreign companies may not be subject to uniform accounting, auditing, and financial reporting standards or to practices and requirements comparable to those that apply to domestic companies. Further, many foreign stock markets are not as developed or efficient as those in the United States. Fixed commissions on transactions on foreign stock exchanges usually are higher than negotiated commissions on U.S. exchanges. The time between the trade and settlement dates of securities transactions on foreign exchanges ranges from one day to four weeks or longer.

2.67 Foreign exchange transactions may be conducted on a cash basis at the prevailing spot rate for buying or selling the currency. Under normal market conditions, the spot rate differs from the published exchange rate because of the costs of converting from one currency to another. Some funds use **forward foreign exchange contracts** as hedges against possible changes in foreign exchange rates. These funds contract to buy or sell specified currencies at specified future dates and prices that are established when the contract is initiated. Dealings in forward foreign exchange contracts may relate to specific receivables or payables occurring in connection with the purchase or sale of portfolio securities, **hedging** all or a portion of a portfolio or the payment of dividends and other distributions.[30]

2.68 The cost of foreign currency transactions varies with such factors as the currency involved, the length of the contract period, and prevailing market conditions. Because exchanges in foreign currencies are usually transacted by principals, most often there are no fees or commissions.

2.69 As an alternative to buying shares of foreign-based companies in overseas markets, investment companies can buy shares in the U.S., denominated in U.S. dollars, for example, **American depository receipts** (**ADRs**).

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[30] Registered investment companies investing in forward foreign exchange contracts are subject to limitations under section 18 of the 1940 Act.

These receipts are for shares of a foreign-based corporation that are held in the vault of a U.S. bank as trustee. The trustee bank collects dividends and makes payments to the holders of the ADR.

2.70 *Valuation of Foreign Securities.* In general, the discussion of valuation of securities in this chapter also applies to foreign securities. Portfolio securities that are traded primarily on foreign securities exchanges should be valued at the functional currency (usually the U.S. dollar equivalent) values for such securities on their exchanges.

2.71 *Other Matters.* In addition to the foreign currency risk associated with investing in foreign securities, such investments present additional risks that need to be assessed continuously by management and considered for financial statement disclosure:

- *Liquidity.* Since certain foreign markets are illiquid, market prices may not necessarily represent realizable value.
- *Size.* When market capitalization is low, a fund's share in the entire market (particularly when single-country funds are involved) or in specific securities may be proportionately very large, and the quoted market price would not necessarily reflect the realizable value.
- *Valuation.* Because of liquidity and size problems as well as other factors, such as securities that are unlisted or securities that are thinly traded, funds would have to adopt specific fair valuation procedures for determining the values of such securities. Doing so may be difficult in a foreign environment; while others may perform the research and provide supporting documentation for fair values, the ultimate responsibility for determining the fair values of securities rests with the directors.

The disclosures suggested above are no different from those that might be required for domestic securities with the same attributes.

2.72 The preceding risks may need to be disclosed in the notes to the financial statements if such factors exist in the markets in which the fund has material investments. It would also be incumbent on management to make sure that prices provided by local sources (such as the last sale price, bid or ask, mean of bid and ask, closing price, and so on) do represent the market value of the securities. This is especially important for open-end funds or closed-end funds that allow limited redemption.[31]

2.73 *Gains and Losses From Foreign Investment Holdings and Transactions.* The differences between originally recorded amounts and currently consummated or measured amounts in the reporting currency are a function of changes in two factors, (*a*) foreign exchange rates and (*b*) foreign market prices. The practice of not disclosing separately the portion of the changes in fair value of investments and realized gains and losses thereon that result from foreign currency rate changes is permitted. However, separate reporting of such gains and losses is allowable and, if adopted, should conform to the guidance that follows. Refer to Appendix F for illustrations of separately calculating and disclosing the foreign currency element of realized and unrealized gains and losses.

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[31] Paragraphs 2.71 and 2.72 of this Guide were incorporated verbatim from paragraphs 37 and 38 of SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies.* Paragraph 37 of SOP 93-4 was intended to provide disclosure guidance only; it was not intended to provide valuation guidance. See paragraphs 2.30 through 2.38 for guidance on valuation of securities.

2.74 A fund investing in foreign securities generally invests in such securities to reap the potential benefits offered by the local capital market. It may also invest in such securities as a means of investing in the foreign currency market or of benefiting from the foreign currency rate fluctuation. The extent to which separate information regarding foreign currency gains or losses will be meaningful will vary depending on the circumstances, and separate information may not measure with precision foreign exchange gains or losses associated with the economic risks of foreign currency exposures. A foreign currency rate fluctuation, however, may be an important consideration in the case of foreign investments, and a reporting entity may choose to identify and report separately any resulting foreign currency gains or losses as a component of unrealized market gain or loss on investments.

2.75 *Bifurcation.* The fair value of securities should be determined initially in the foreign currency and translated at the spot rate on the date of purchase. The unrealized gain or loss between the original cost (translated on the trade date) and the fair value (translated on the valuation date) comprises the following elements:

a. Movement in foreign currency denominated fair value

b. Movement in foreign currency exchange rate

2.76 Such movements may be combined or bifurcated (that is, separate disclosure of the foreign currency gains and losses). If **bifurcation** is chosen, the movement in foreign currency denominated fair value should be measured as the difference between the fair value in foreign currency and the original cost in foreign currency translated at the spot rate on the valuation date. The effect of the movement in the foreign exchange rate should be measured as the difference between the original cost in foreign currency translated at the current spot rate and the historical functional currency cost. Fair value can be computed as follows:

a. (Fair value in foreign currency minus original cost in foreign currency) × valuation date spot rate = **unrealized appreciation or depreciation**.

b. (Cost in foreign currency times valuation date spot rate) – cost in functional currency = the unrealized foreign currency gain or loss.

2.77 For short-term securities held by a fund that uses amortized cost as a surrogate for fair value, the amortized cost value should be substituted for fair value in the formulas above if separate reporting is chosen by the reporting entity.

2.78 *Sales of Securities.* If bifurcation is chosen by the reporting entity, the computation of the effects of the foreign currency denominated fair value change and the foreign currency rate change is similar to that described in paragraph 2.76. Fair value in the formula given in paragraph 2.76 should be replaced with sale proceeds and valuation date should be replaced with sale trade date, as follows:

a. (Sale proceeds in foreign currency – original cost in foreign currency) × sale trade date spot rate = realized market gain or loss on sale of security.

b. (Cost in foreign currency × sale trade date spot rate) – cost in functional currency = realized foreign currency gain or loss.

2.79 The sale of a security results in a receivable for the security sold. That receivable should be recorded on the trade date at the spot rate. On the settlement date, the difference between the recorded receivable amount and the actual foreign currency received converted into the functional currency at the spot rate is recognized as a realized foreign currency gain or loss.

2.80 *Purchased Interest and Sale of Interest.* Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase. It should be recorded in the functional currency as interest receivable at the spot rate on the purchase trade date, and marked to market using each valuation date's spot rate. After the settlement date, daily interest income should be accrued at the daily spot rate. It may be impractical to prepare the foregoing calculations daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

2.81 Interest sold represents the accrued interest receivable between the last coupon date and the settlement date of sale of the security. The difference between the recognized interest receivable amount and the actual foreign currency received (converted into the functional currency at the spot rate) should be recognized as a realized foreign currency gain or loss.

2.82 *Receivables and Payables.* All receivables and payables that are denominated in a foreign currency relating to income or expense, or to securities sold or purchased, should be translated into the functional currency each valuation date at the spot rate on that date. The difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items, and at the trade date spot rate in the case of sales and purchases of securities, is unrealized foreign currency gain or loss. Upon liquidation of the receivable or payable balance in a foreign currency, the difference should be reported as realized foreign currency gain or loss.

2.83 *Cash.* Foreign currency cash balances and movements should be accounted for in the same manner as foreign currency-denominated securities. Every receipt of a foreign currency should be treated as a purchase of a security and recorded in the functional currency at the spot rate on the cash receipt date. Similarly, every disbursement of a foreign currency should be treated as a sale of a security and the appropriate functional currency cost should be released, depending on whether a specific identified cost, first-in, first-out (FIFO) method, or average cost method is used.

2.84 The acquisition of foreign currency does not result in any foreign currency gain or loss. However, the disbursement of foreign currency results in a realized foreign currency gain or loss that is the difference between the functional currency equivalent of the foreign currency when it was acquired and the foreign currency disbursement translated at the spot rate on the disbursement date. Also, as is the case with all other assets and liabilities denominated in foreign currency, foreign currency cash balances should be translated on each valuation date at the spot rate on that date, resulting in unrealized foreign currency gain or loss.

2.85 *Dividends and Interest.* Dividend income on securities denominated in a foreign currency should be recorded on the ex-dividend date, using the spot exchange rate to translate the foreign currency amount into the functional currency on that date. The related dividend receivable should be translated into the functional currency daily at the spot rate, and the difference between the dividend accrued in the functional currency and the foreign currency receivable at the valuation date spot rate is unrealized foreign currency gain or loss. When the dividend is received, the unrealized foreign currency gain or loss should be reclassified as realized foreign currency gain or loss.

2.86 The preceding approach to measuring investment income ensures that investment income accrued on foreign securities reflects the investment transaction without regard to the foreign currency gain or loss created in the time between the accrual and collection of the income.

2.87 Interest on securities denominated in a foreign currency should be accrued daily in the foreign currency at the stated interest rate and translated into the functional currency at the daily spot rate. It may be impractical to prepare such a calculation daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

2.88 The related receivable balance along with purchased interest, if any, should be accumulated in the foreign currency and translated into the functional currency daily using the spot rate for that date. The difference between the income accrued in the functional currency and the foreign currency receivable at the valuation date spot rate is unrealized foreign currency gain or loss.

2.89 When the interest is received and recorded in the functional currency at the spot rate on that date, the unrealized foreign currency gain or loss should be reclassified as realized foreign currency gain or loss.

2.90 Recording dividends on foreign securities is often difficult because, in certain countries, companies customarily declare dividends retroactively or there is a lack of timely information. Additionally, in some countries, the sequencing of the declaration date and ex-dividend date may be different from the sequencing of these dates in the United States, thus necessitating a modification of the practice of recording dividends on the ex-dividend date (see paragraph 2.46). Also, foreign companies often declare stock dividends instead of cash dividends or take other corporate actions such as issuing rights or warrants. The SEC staff has stated that delayed recording of foreign corporate actions may be acceptable for registered investment companies if the investment company, exercising reasonable diligence, did not know that the corporate action had occurred; in such event the investment company should record the action promptly after receipt of the information.[32]

2.91 *Amortization.* Amortization of premiums and discounts on bonds should be calculated daily in the foreign currency. The resulting amount of income or offset to income should be translated into the functional currency using that day's spot rate. The same foreign currency amount should be recorded as an addition to cost for amortization of discount and a reduction to cost for amortization of premiums. Accordingly, cost consists of the original cost, translated at the spot rate in effect on the trade date the bond was bought, adjusted for discount or premium amortization at the spot rate on the date of adjustment. As stated in paragraph 2.87, use of a weekly or monthly average rate may be appropriate in certain circumstances.

2.92 On maturity, the carrying cost (including accretion or amortization) of the security in the foreign currency equals the proceeds. However, this will

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[32] Letter of SEC Division of Investment Management Chief Accountant to Investment Company Chief Financial Officers, November 1, 1996.

not be the case in the functional currency. The original cost is translated into the functional currency at the spot rate on the trade purchase date and the accretion or amortization is translated at periodic spot rates. The proceeds are translated into the functional currency at the spot rate on the maturity date. The difference between the proceeds and the accumulated cost in the functional currency is realized foreign currency gain or loss.

2.93 *Withholding Tax.* Dividends and interest received from foreign investments may result in withholding taxes and other taxes imposed by foreign countries, usually at rates from 10 percent to 35 percent. Tax treaties between certain countries and the United States may reduce or eliminate such taxes. Many foreign countries do not tax **capital gains** on investments by foreign investors; however, if such gains are taxable, an accrual for capital gains taxes payable on both realized and unrealized gains should be included in the net asset value per share calculation. The auditor should review the collectibility of recorded receivables if withholding taxes have been reclaimed.

2.94 When tax is to be withheld from investment income at the source, the amounts to be withheld that are not reclaimable should be accrued at the same time as the related income on each income recognition date if the tax rate is fixed or estimable. If a tax withheld is reclaimable from the local tax authorities, the tax should be recorded as a receivable and not as an expense. When the investment income is received net of the tax withheld, a separate realized foreign currency gain or loss should be computed on the gross income receivable and the accrued tax expense. If the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount is received; accordingly, there would be no foreign currency gain or loss. However, if a receivable is recorded, there may be a foreign currency gain or loss through the date such receivable is collected.

2.95 Taxes withheld that are not reclaimable, if any, on foreign source income should be deducted from the relevant income item and be shown either parenthetically or as a separate contra item in the income section of the statement of operations. See paragraph 7.83 for illustrative disclosure.

2.96 *Expenses.* The accounting for expenses payable in a foreign currency is analogous to that for investment income receivable in a foreign currency. An expense should be accrued as incurred and translated into the functional currency at the spot rate each day. The use of an average weekly or monthly foreign currency rate would be acceptable if the foreign currency rate does not fluctuate significantly. The related accrued expense balance should be accumulated in the foreign currency and translated into the functional currency daily, using the spot rate for that date. The difference between the expense accrued in the functional currency and the related foreign currency accrued expense balance translated into the functional currency at the valuation date spot rate is unrealized foreign currency gain or loss. When the expense is paid, the unrealized foreign currency gain or loss should be reclassified as realized foreign currency gain or loss.

2.97 *Safekeeping of Foreign Assets.* Investing in foreign securities often involves custodial or subcustodial agreements with U.S. banks and their foreign branches, as well as foreign banks and trust companies, for the safekeeping of fund assets held outside the United States. Rule 17f-5 of the 1940 Act permits registered investment companies to maintain their foreign securities with eligible foreign custodians (for example, foreign banks and trust companies that meet certain requirements, securities depositories, and clearing agencies). Rule 17f-5 sets forth the conditions that must be included in the foreign custody agreement, as well as the specific responsibilities of the investment company's board of directors in reviewing and approving the arrangements. Additionally, Rule 17f-7 establishes conditions under which an investment company may place its assets in the custody of a foreign central securities depository.

Consideration of Fraud in a Financial Statement Audit

2.98 Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). (SAS No. 99 also amends SAS No. 85, *Management Representations.*)

2.99 There are two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

2.100 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

2.101 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs 14–18 of SAS No. 99. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

Examples of Fraud Risk Factors

2.102 The following are examples of conditions that may indicate the presence of fraud in investment companies. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: Fraudulent Financial Reporting

A. *Opportunities*

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

    a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

    (1) Significant transactions with affiliates that are not approved by the board of directors in accordance with Section 17 of the Investment Company Act.

    (2) Transactions involving affiliates that are not readily apparent in the circumstances, or apparent but not properly disclosed.

    b. Significant investments for which readily available market quotes are not available and inadequate procedures for estimating these values.

    c. Significant investments in derivative financial instruments for which value is very difficult to estimate.

2. Internal control components are deficient as a result of the following:

    a. A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.

    b. Unusual and considerable influence of the portfolio manager over pricing sources and fair valuation methodology used to value securities.

    c. Lack of board's involvement in the establishment of the fair valuation policies and procedures or lack of oversight over those policies and procedures.

    d. Ability of management to unilaterally override internal control system, particularly security valuations.

    e. Lack of adviser's supervisory or oversight procedures over its own employees and/or the subadviser.

f. Inadequate controls around the calculation of the net asset value.

g. Reconciliation of security holdings with the custodian that are infrequent and incomplete.

h. Inadequate monitoring of the fund's tax status as a regulated investment company.

i. Inadequate monitoring of the fund's compliance with its prospectus requirements.

j. Transfer agency controls are ineffective or implementation of user controls are ineffective.

k. Lack of an appropriate policy regarding corrections of net asset value errors, or failure to comply with policy.

l. Lack of board members' understanding of how portfolio management intends to implement the fund's investment objectives, thereby creating a situation in which management can aggressively interpret or disregard policies in place.

m. Lack of board members' understanding of derivatives used by portfolio managers and involvement in approving or disapproving use of specific strategies such as embedded leverage, thereby creating a situation in which management can aggressively interpret or disregard policies in place.

n. Incomplete or insufficient description of portfolio positions in accounting records to permit adequate monitoring of prospectus requirements.

B. *Attitudes/Rationalizations*

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of:

1. Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.

   a. An excessive focus on maintaining a high rate of dividend payments regardless of the fund's actual investment income.

   b. Significant amounts of investments are valued by management, either judgmentally or through valuation models.

2. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations.

   a. Past suspensions of ability to act as an investment adviser or requirement that the adviser be supervised by others.

   b. Significant deficiencies cited in inspection letters by SEC or other regulatory bodies, with heightened emphasis on deficiencies cited in prior inspections that management has not remedied.

3. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts.
    a. Commitment to preserve principal or to maintain a certain income or distribution yield.
4. Adviser's fee revenues (including performance incentives) directly related to either the value of fund assets or performance, if the adviser has substantial discretion in valuing portfolio investments and changes in fee revenues may be significant to the adviser.
5. Undisclosed use of soft-dollar credits and other items to reduce a gross ratio below a cap so the adviser does not have to reimburse the fund for excess expenses.

Part 2: Misappropriation of Assets

Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

A. *Opportunities*

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
    a. Use of soft dollar arrangements for the benefit of the adviser without client consent (including existence of undocumented or ill-defined arrangements).
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
    a. Access to funds and securities and accounting for them directly controlled by adviser, with inadequate segregation of duties (or no direct communication between custodian and accounting personnel).
    b. Lack of any periodic review of a transfer agency's control design and operation by an independent auditor knowledgeable in the area (such as a SAS No. 70 report).
    c. Infrequent and incomplete reconciliation of security holdings with the custodian.
    d. Lack of clearly defined policy with respect to personal investing activities (for example, front-running fund trades or taking investment opportunities for personal use).
    e. Ineffective transfer agency controls or ineffective implementation of user controls in a service center environment, particularly inadequate controls over uncashed dividend/redemption check listings, returned by post office (RPO) and other inactive shareholder accounts, and reconciliations of transfer agency bank accounts.

f. Lack of segregation of duties between portfolio management and trading, or absence of independent review of trading executions (for example, unexpected concentrations of trading with counterparties, poor trade executions, or higher-than-normal commissions that may indicate existence of collusion between portfolio personnel and counterparties).

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

2.103 SAS No. 22, *Planning and Supervision* (AU sec. 311.06–.08), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs 35 through 42 of SAS No. 99) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs 20 through 27 of SAS No. 99.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30 of SAS No. 99.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs 31 through 33 of SAS No. 99, the Appendix to SAS No. 99 and paragraphs 2.102, 2.105, and 2.106.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34 of SAS No. 99.)

2.104 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. For example, in the investment company industry, the following unusual or unexpected relationships may indicate a material misstatement due to fraud:

a. Investment performance substantially higher (or lower) when compared to industry peers or other relevant benchmarks, which cannot be readily attributed to the performance of specific securities where prices are readily available in an active market. Particular considerations include:

(1) Significant gains (or losses) from securities held for extremely short periods of time

(2) Significant gains (or losses) from instruments not typically acquired by the fund

b. Unusually high levels of investment purchases and sales in relation to total fund net assets without apparent economic purpose.

c. Net investment income ratio substantially higher than competitive universe, particularly in a fund marketed with the objective of making current income distributions.

d. Expense ratios that change significantly from year to year with inadequate reasoning.

e. Expense ratios and transaction costs exceed industry norms.

f. Significant differences between the prices at which securities are sold to third parties from the values reflected in the Fund's net asset value in the days prior to sale.

2.105 ***Considering Fraud Risk Factors.*** As indicated in item 2.103(*c*) above, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

2.106 SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph 2.102 contains a list of fraud risk factors specific to the investment company industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

2.107 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs 19 through 34 of SAS No. 99. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

2.108 Although, due to daily valuation requirements, there are only a few areas in investment companies' financial statements that require significant judgment, the fact that significant amounts of investments are valued by management, either judgmentally or through valuation models, presents a number of risks that need to be addressed by the auditor. The following risk factors related to fair valuation of investments should be considered:

a. Lack of approval and/or oversight of fair valuation policy by the board of directors

b. Lack of specificity in fair valuation policy and procedures

c. Lack of consistency in application of valuation procedures

d. Inordinate influence of portfolio management personnel over fair valuation decisions

e. Apparent fair valuation when market values may be readily available

f. Lack of monitoring/follow-up of fair valuation actions taken *g.* Lack of evidence for fair valuation decisions made

h. Significant amounts of investments traded in "thin" markets, particularly through one market maker (either exclusively or primarily)

i. For securities not traded in organized markets (in particular, private placements) determination of whether a purchase of investments has occurred requiring the initiation of valuation procedures, or whether a sale has occurred for recognition of realized gain/loss

2.109 In addition to fair valuation, risks are present in daily market valuation as well. Risks to be considered include:

a. Use of a pricing service with inadequate capabilities or controls

b. Ability of portfolio management or other unauthorized individuals to override prices

c. Lack of consideration of or availability of secondary/comparative pricing sources

d. Significant levels of pricing from brokers

e. Manual entry or override of prices

2.110 Derivative instruments are another class of transactions characterized by high inherent risk. The following risk factors should be considered for derivatives:

a. Lack of policy governing derivative investments, including a clear definition of derivatives

b. Lack of oversight over the use of derivative investments, including ongoing risk assessment of derivative instruments

c. Lack of adequate procedures to value derivatives

d. Lack of awareness or understanding of derivative transactions on the part of senior management or the board of directors

2.111 Trading of investment securities also poses some risks, including the following factors:

a. Lack of segregation of duties between portfolio management and trading functions

b. Lack of developed and consistently applied and enforced trade allocation policy

c. Trading through unapproved counterparties

d. Lack of enforcement of personal trading (code of ethics) policy

e. Lack of monitoring of commission levels and volume of trading by broker

2.112 The following factors should be considered for transfer agency/capital stock activity:

a. High volume of cancel/rebook or "as-of" activity

b. Credible shareholder complaints

c. Activity on dormant accounts

d. Inadequate segregation of duties among mail processing, transaction processing, and reconciliation functions

e. Inadequate segregation of duties within transaction processing, such as allowing processors to change address or banking instructions and initiate a redemption

2.113 Other areas that need to be considered because they involve a high degree of management judgment and subjectivity and are susceptible to manipulation by management include the following:

a. Income recognition on high-yield debt instruments where collectibility is in question, or on asset-backed securities requiring significant estimates as to the timing of expected cash flows

b. Major judgments made in determining that a regulated investment company has qualified for pass-through status under Subchapter M of the Internal Revenue Code, which may include determining "issuers" for diversification status, major determinations of classification of revenue items as ordinary income or (long-term) realized gain, and satisfaction of minimum distribution requirement

c. Significant elements of incentive fee computations (including computation of any benchmarks against which performance is to be measured)

A Presumption That Improper Revenue Recognition Is a Fraud Risk

2.114 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (See paragraph 41 of SAS No. 99).

2.115 The risk of material misstatement of an investment company's financial statements due to improper revenue recognition will often be considered inherently low. For securities traded on active markets valuations can be readily established, interest on fixed-income securities can be readily computed as the product of coupon rate and par value while dividend income can be readily determined through use of widely-available reporting sources. The more a particular fund departs from this model, the greater the risk of material misstatement due to fraud relating to revenue recognition. For example, as discussed above, revenue recognition on certain asset-backed securities depends heavily on management's estimation of future cash flows, and management must estimate collectibility of interest (including unamortized discount) on high-yield securities where the underlying issuer is evidencing financial difficulty.

2.116 Various risks exist to the extent that securities cannot be valued on the basis of prices determined on an active market:

- To the extent that management is estimating the value of portfolio investments, even through generally recognized models, the risk of fraudulent misstatement through systematic bias ordinarily exists.
- If an investment is valued through a single market maker (often the counterparty that sold the investment to the investment company), there is a risk that collusion occurred between that market maker and management in establishing a valuation for the investment.
- In many cases independent valuation services provide estimates of value for fixed-income securities based on observable market transactions and financial information (including security ratings) available publicly, in some cases the services estimate value for securities that are not traded in the market and for which the investment company may

be predominant, or sole, holder. In those cases, the investment company may be the predominant, or sole, source of information the pricing service uses to estimate value. In these infrequent cases, there is a risk that the information provided by management to the service is incomplete or otherwise biased.

- If the market for a security is "thin," there is a risk that the investment company (or related investment companies) may be able to manipulate the quoted price by systematic purchases of the security in the market. An auditor would not ordinarily be expected to identify price manipulation, but may be able to identify a "thin" market, in which trades are typically sporadic, so that small changes in supply or demand can have a significant effect on quoted prices. Usually, such securities only have an extremely small "float" (i.e., freely tradable amounts owned by the public).

2.117 The following factors need to be considered related to recognition of interest and dividend revenues:

- Cash receipts for interest or dividend payments are significantly different from accrued amounts.
- Receivable balances include potentially uncollectible interest or dividends, such as significantly overdue amounts.
- Interest or dividend accrual policies do not comply with GAAP or are not enforced.
- Daily interest income is erratic rather than reasonably consistent.
- Procedures in place to identify dividends earned are lax.
- Interest or dividends receivable may be written off without independent approval.

2.118 The following factors need to be considered with respect to revenue recognition for realized and unrealized gains:

- Stated policy for purchase lot selection on security sales is not followed.
- Realized gains are not properly calculated on sales.

2.119 Auditor also needs to ensure that an investment company does not record capital contributions from affiliates as revenues (see paragraphs 7.49 through 7.51 for guidance on the accounting for payments by affiliates and corrections of investment restriction violations.)

A Consideration of the Risk of Management Override of Controls

2.120 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph 57 of SAS No. 99) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs 58 through 67 of SAS No. 99 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Key Estimates

2.121 The financial statements of investment companies are typically less complicated than those of other enterprises and have relatively few estimates.

Most key estimates relate to revenue recognition, including portfolio valuation, as well as interest recognition on high-yield and asset-backed securities, which are discussed in paragraphs 2.113, 2.115, and 2.116. Material expense accruals (in particular, performance fees) and estimates of shareholder activity for previous day pricing clients can also require significant estimation procedures.

2.122 Often, non-accounting estimates are integral to measuring a portfolio's compliance with its investment objective and characteristics (for example, the "duration" of a fixed-income portfolio often is a key characteristic, and estimates are required to measure the duration of asset-backed and other securities subject to prepayment). While these non-accounting measures typically are not explicitly tested in an audit of financial statements, the auditor should be aware of their existence and consider how their use is controlled by management.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

2.123 Auditors should comply with the requirements of paragraphs 43 through 45 of SAS No. 99 concerning an entity's programs and controls that address identified risks of material misstatement due to fraud.

2.124 Most investment advisors maintain extensive portfolio management controls, including:

- separation of portfolio management and trading functions
- attribution analysis—an explanation of portfolio performance against a stated benchmark, identifying industry or security exposures that caused the performance difference, to assist management in identifying abnormal items for their own follow-up
- dispersion analysis—comparing performance of similar portfolios managed by the same individual or group, with analysis of any outlying performance), to assist management in identifying abnormal items for their own follow-up
- Frequent reconciliation of cash and portfolio holdings to custodian records
- Comparison of trade terms to broker confirmation prior to recording the transaction
- Extra level of approval required for nonstandard wire transfers
- Monitoring of activity on dormant shareholder accounts
- Review of nonstandard journal entries

2.125 Many investment companies also maintain extensive controls over valuation of securities not traded on active markets, including:

- Written valuation policies and procedures
- Valuation committees, composed of accounting, portfolio management, and administrative or legal personnel, to assess valuation procedures and significant valuation estimates. Some registered investment companies place such committees under the oversight of the Board of Directors/Trustees and occasionally Board members will participate in committee deliberations on significant matters.
- Tracking of actual sale prices against valuations as determined by management or market makers.
- Use of secondary pricing services for comparison to primary source

- "Stale price" and "large price change" reports to identify securities for which prices may not have been updated on a timely basis, or which have experienced unusual or abnormal changes.
- Segregation of portfolio management from valuation functions

2.126 Examples of broader programs designed to prevent, deter, and detect fraud include:

- Code of conduct regarding ethical behavior compliance with which is typically documented
- Code of ethics regarding personal trading compliance with which is typically documented
- Compliance programs
- Periodic documentation of compliance of an investment company with its investment objectives and restrictions
- Systems controls such as security access
- Channels available for employees to report any fraud concerns

2.127 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

2.128 Paragraphs 46 through 67 of SAS No. 99 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph 50 of SAS No. 99).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs 51 through 56 of SAS No. 99). Investment company audit procedures that may be considered include:
    - Analytical procedures such as comparing fund performance to benchmark indices and net investment income ratios to yield indices for comparable securities or investment funds;
    - Reading compliance summaries for individual funds and testing compliance determinations contained therein;
    - Comparisons of valuations of securities determined by management or a single market maker during the year to prices received on actual sales;
    - Attempting to obtain market quotations for certain securities from broker/dealers or recognized pricing sources other than the primary pricing source (however, this may not always be possible and, even when received, the quotations received may be of lesser quality as the other source may not have the same access to information about the security as the primary source);

- Testing inputs to valuation models for reasonableness in relation to published data or financial information services;
- Reviewing minutes of Board valuation committee meetings and considering whether the minutes adequately support valuations determined, or the procedures used to reach them;
- Testing management's assumptions regarding collectibility of interest or projected cash flows for asset-backed securities by reference to issuer data available from public sources or financial information services.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs 57 through 67 of SAS No. 99 and paragraph 2.123 (*b*) above).

Evaluating Audit Evidence

2.129 Paragraphs 68 through 78 of SAS No. 99 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

2.130 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

2.131 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs 75 through 78 of SAS No. 99 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

2.132 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[33]

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[33] See SAS No. 58 for guidance on auditors' reports issued in connection with audits of financial statements.

b. Consider the implications for other aspects of the audit (see paragraph 76 of SAS No. 99).

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.[34]

d. If appropriate, suggest that the client consult with legal counsel.

2.133 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

2.134 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs 79 through 82 of SAS No. 99 for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

2.135 Paragraph 83 of SAS No. 99 requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

2.136 The AICPA Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this Practice Aid provides an understanding of the differences between the requirements of SAS No. 99 and SAS No. 82, which was superseded by SAS No. 99. This Practice Aid is an Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Auditing Procedures

2.137 SAS No. 92,[35] *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards,* vol. 1, AU sec. 332), provides guidance on auditing investments in debt and equity securities, investments accounted for under APB Opinion No. 18, and derivative instruments and

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[34] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

[35] For guidance on implementing the requirements of SAS No. 92, the reader should refer to the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities.*

hedging activities. Practitioners should refer to the auditing considerations and requirements of SAS No. 92, as applicable, for the guidance. In January 2003, the ASB issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted. The audit of an investment company's investment accounts is a significant portion of the overall audit because of the relative significance of those accounts and of the related income accounts. In auditing the investment accounts, the auditor should consider various aspects of the investment company's transactions with brokers, custodians, and pricing services.

2.138 Economic conditions in the jurisdictions in which funds invest may affect the auditor's assessment of inherent risk for assertions in investment companies' financial statements. Factors that auditors should consider include local rates of inflation, government stability, and local tax rules. Auditors should consider whether such indicators create, intensify, or mitigate inherent risk.

2.139 An auditor ordinarily does not have a sufficient basis for recognizing possible violations of security regulations or laws concerning compliance with investment restrictions as they relate more to the entity's operating aspects than to its financial and accounting aspects. Even when violations of such laws can have consequences material to the financial statements, the auditor may not become aware of the existence of these illegal acts unless the auditor is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information inspected in an audit of financial statements.

2.140 The auditor should review such relevant investment company documents as the latest prospectus, statement of additional information, certificate of incorporation, bylaws, and minutes of the board of directors' and shareholders' meetings to gain an understanding of the investment company's investment objectives and restrictions, and consider whether management has a program to prevent, deter, or detect noncompliance with the investment company's investment restrictions. The auditor should also consider whether the program has identified noncompliance with the stated investment restrictions and test the operation of the program to the extent considered necessary. An investment company's failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the fund. Should an auditor become aware of the possibility of an illegal act, the procedures delineated in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), should be applied. Auditors may also be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in section 10A(b)1 of the Securities Exchange Act of 1934) to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

2.141 As part of the certification of financial statements required by the Sarbanes-Oxley Act of 2002, the principal executive officer and principal financial officer of an investment company filing financial statements on Form

N-CSR are required to disclose to the investment company's audit committee and independent auditors all significant deficiencies in the design or operation of internal controls which could adversely affect the investment company's ability to record, process, summarize and report financial data, and to identify to the auditors any material weaknesses in internal controls. Further, they are to disclose to the audit committee and the auditors any fraud, whether or not material, that involves management or other employees who have a significant role in the investment company's internal controls.

Principal Audit Objectives

2.142 The principal objectives in auditing the investment accounts are to provide reasonable assurance that—

- The investment company has ownership of and accounting control over all of its portfolio investments.
- All transactions are authorized and recorded in the accounting records in the proper account, amount, and period.
- Portfolio investments are valued properly, and their costs are recorded properly.
- Income from investments and realized gains and losses from securities transactions are accounted for properly.
- Investments are free of liens, pledges, or other security interests or, if not, that such matters are identified properly and disclosed in the financial statements.

Consideration of Internal Control

2.143 Establishing and maintaining internal control is an important management responsibility. In establishing specific controls that will enable an investment company to record, process, summarize, and report financial data that is consistent with management's assertions in the financial statements, management may wish to consider the following specific objectives:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to such statements and to maintain accountability for assets.
- Transactions are valued in a manner that permits recording their proper monetary value in the financial statements.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.[36]

2.144 The second standard of fieldwork states that "A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." Form N-SAR requires

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[36] Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, and by SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, paragraph 10 (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

auditors of registered investment companies to report on an investment company's internal control, including those controls exercised on behalf of the company by agents acting as custodians. The report, which is filed with the fiscal year-end Form N-SAR, is based solely on the procedures performed as part of the audit.

2.145 The location of the investment securities should be ascertained by the auditor. The auditor should determine whether and to what extent management and the board have evaluated the investment company's relationship with the securities' custodian in terms of significant recordkeeping responsibilities, financial stability, operational capabilities, and other matters pertaining to the relationship. The auditor should obtain an understanding of the custodian's internal control to the extent the auditor considers such an understanding necessary to plan the audit and to determine the nature, timing, and extent of tests to be performed. A custodian's controls that may be relevant to an audit of an investment company's financial statements might include, among others, the following:

- Controls covering the receipt of and payment for securities, delivery of securities, and control over cash received
- Controls for physically segregating and satisfactorily safeguarding the company's securities in the custodian's vaults
- Physical counts of securities and other procedures performed by the custodian's internal auditors
- Controls over securities held in central depositories
- Controls over receipts of cash including dividend and interest payments

2.146 If the custodian has engaged a service auditor to examine the custodian's description of controls over custodial functions, the fund's auditor should consider obtaining a copy of the service auditor's report. The auditor's use of service auditors' reports is discussed in paragraphs 4.53 through 4.58. Further guidance is provided in SAS No. 70, *Service Organizations*[37] (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

2.147 An investment company may enter into subcustodial arrangements for investments in securities with institutions both inside and outside the United States.[38] The auditor should obtain an understanding of the extent of intercustodial responsibilities and rights under subcustodial agreements. For arrangements with foreign subcustodians, the auditor should consider inquiring as to the procedures undertaken by the fund's directors in evaluating the subcustodial arrangement. Additionally, the principal custodian may perform oversight procedures, particularly over foreign subcustodians, that are relevant to the auditor when considering the extent of audit procedures to be applied to

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[37] In September of 2002, the Auditing Standards Board (ASB) issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Among other things, SAS No. 98 amends SAS No. 70, *Service Organizations* (AU sec. 324.57–.60), to require a service auditor to inquire of management about subsequent events. The previous guidance, in Auditing Interpretation No. 6 of SAS No. 70, stated that a service auditor should consider inquiring of management about subsequent events. SAS No. 98 also rescinds Auditing Interpretation No. 6 of SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003. Earlier application is permissible.

For more information on SAS No. 70 readers should refer to the Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended,* which includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

[38] SEC Release No. 12354 under the 1940 Act.

subcustodians. The auditor may consider applying audit procedures to each subcustodial arrangement that is similar to those for principal custodians if the existence assertion is not supported satisfactorily through the other procedures listed above.

2.148 If an investment company enters into repurchase or **securities lending** agreements, the auditor should consider whether the company's internal control includes the following:

- A review of the creditworthiness of the issuers of repurchase agreements or counterparties for stock-lending arrangements
- A requirement that actual or constructive possession of the collateral be taken by the investment company, its custodian, or by a custodian qualified under the 1940 Act, who verifies that the collateral is being held for the investment company
- A requirement to mark the collateral to market daily during the entire period of the agreement
- A requirement that such agreements provide that additional collateral be deposited by the issuer if the fair value of the collateral falls below the repurchase price or stock loan value[39]

The auditor should also consider inspecting the terms of the agreements and assessing the related accounting and disclosure in accordance with the criteria of FASB Statement No. 140.

Examination of Transactions and Detail Records

2.149 *Custody of Securities.* For a registered investment company, the auditor should confirm all securities with the custodian, including securities held by the custodian on behalf of the investment company in a central securities system or similar omnibus account, or physically examine the securities as applicable under the circumstances. Additionally, the SEC requires the auditor to confirm all unsettled securities purchased with the party responsible for delivery. For those confirmations not received, the auditor should perform alternative procedures deemed appropriate in the circumstances.[40] For nonregistered investment companies, the timing and extent of testing custody is a matter of the auditor's judgment.

2.150 Other procedures typically include:

- Confirmation of **when-issued** transactions with the underwriter, including the value of such transactions as of the valuation date.
- Confirmation of commodity **futures contracts**, financial futures contracts, and swaps with the clearing broker or counterparty.
- Confirmation of forward contracts, **standby commitment contracts**, and repurchase agreements (with the counterparty). For forward contracts, standby commitments, and reverse repurchase agreements, the auditor should consider reviewing the contracts or agreements and consulting with the investment company's legal counsel to determine if a senior security, as defined in section 18(g) of the 1940 Act, exists.
- Confirmation of short securities positions with the broker.
- Confirmation of borrowed or loaned securities and related collateral with the broker or counterparty.

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[39] SEC Release No. 13005 under the 1940 Act.

[40] SEC, *Codification of Financial Reporting Policies*, section 404.03.

- Confirmation of **put** or **call options** with the company's broker or with the counterparty.

2.151 Under certain conditions, section 17 of the 1940 Act and rules promulgated thereunder, principally rules 17f-1 and 17f-2, require additional examinations of securities. When possible, in carrying out the examination, the auditor is to make a physical examination of the securities themselves. The auditor is also required to confirm securities not held in physical form or in transit at the examination date.[41, 42] In all cases, the auditor is also required to reconcile the physical count or confirmation with the fund's accounting records.

2.152 The exact requirements for frequency and timing of examinations depend on the kinds of custodial arrangement.[43] The kind of custodial arrangements and requirements include the following:

- An investment company maintaining a custodial relationship with a member of a national securities exchange should follow rule 17f-1 of the 1940 Act. That rule requires the investment company's auditor to examine all securities at the end of each annual and semiannual fiscal period and at least one additional time during the fiscal year chosen by the auditor, without advance notification to the custodian.
- An investment company that retains possession of its securities or that maintains its securities in the custody of an affiliated bank should follow rule 17f-2 of the 1940 Act. That rule requires the company's auditor to examine the securities at least three times in each fiscal year. The dates for at least two of the inspections should be chosen by the auditor without notice to the investment company.[44] The third inspection should be performed by the auditor at fiscal year-end.

After each examination, the auditor should address a report to the investment company's board of directors. The auditor is required to submit promptly a copy of that report to the SEC stating that such an examination was performed and describing the work done and the results. An illustration of such a report is provided in chapter 11.

2.153 *Tests of Portfolio Transactions.* The auditor rarely considers it necessary to examine all transactions during the period under audit, unless specifically requested to do so, and selects a sample of portfolio transactions for testing. Brokers' advices or other documents should be examined to ascertain that they agree with the entries recorded in the purchase, sales, or general journals or other books of original entry. The auditor should consider testing for proper authorizations, extensions, trade dates, and reasonableness of the transaction prices. The auditor should also consider testing whether sales have been properly accounted for during the period, that an acceptable method of costing sales (specific identification or average-cost) has been applied consistently, and that gains or losses have been calculated properly.

2.154 The auditor should consider testing the classification of gains and losses for tax purposes and the adjustments to the bases of investments resulting

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[41] SEC, *Codification of Financial Reporting Policies*, section 404.01.a.

[42] Because custodians no longer hold most securities in physical form and custody relationships may extend through two or more levels of subcustodians (especially when funds invest in non-U.S. markets), the confirmation requirements of rule 17f-2 are fulfilled when the auditor confirms security holdings with the highest-level unaffiliated subcustodian.

[43] See footnote 40.

[44] Rule 17f-2 of the 1940 Act.

from stock dividends, splits, rights, recapitalizations, and liquidating dividends.

2.155 *Portfolio Transactions With Affiliates.* Section 17 of the 1940 Act and related rules impose significant restrictions, and in some cases prohibitions, on transactions with affiliates. The terms *affiliate* and *control* in the 1940 Act have different meanings from their definitions in FASB Statement No. 57, *Related Party Disclosures*; specifically, the term *affiliate* means an affiliated person as defined in section 2(a)(3) of the 1940 Act, and the term *control* has the meaning given in section 2(a)(9) of the 1940 Act. The term *affiliated person* as defined in section 2(a)(3) of the 1940 Act encompasses control relationships and the direct or indirect ownership of 5 percent or more of the outstanding voting securities of any issuer. An affiliated person, as defined in that section, includes officers, directors, partners, employees, investment advisers, and members of the investment adviser's advisory board.

2.156 Regulation S-X requires disclosure of more information about transactions with affiliates in prospectuses and annual reports to the SEC than is required under generally accepted accounting principles. Various rules of Regulation S-X require the financial statements of an investment company to state separately investments in affiliates, investment income from affiliates, gain or loss on sales of securities of affiliates, and **management fees** or other service fees payable to **controlled companies** and other affiliates.

2.157 In auditing a registered investment company, the auditor should be familiar with section 17 of the 1940 Act and related rules. The guidance for auditing related party transactions in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), may be applied equally in ascertaining the existence of 1940 Act affiliates and auditing transactions with them. Further, in addition to the recommended written representation as to the existence of related party transactions, in the audit of a registered investment company the auditor should obtain written representations from management that, except to the extent indicated, the company—

- Does not own any securities either of directly affiliated or, to the best information and belief of management, indirectly affiliated entities.
- Has not received income from, or realized gain or loss on sales of, investments in or indebtedness of such affiliated entities.
- Has not incurred expenses for management or other service fees payable to such affiliated entities.
- Has not otherwise engaged in transactions with such affiliated entities.

Paragraph 11.23 presents an illustrative management representation letter. If there is a question as to whether a relationship represents an affiliation, the auditor should consider requesting that the investment company's management obtain a written opinion from legal counsel.

2.158 If affiliated entities exist, such as an underwriter or investment adviser, such auditing procedures as confirmation of transactions, examination of supporting documents, and written representations from the management of affiliated entities may be needed. These procedures are necessary because the fund is required, by rules under the 1940 Act, to disclose amounts paid to affiliates in connection with their services to the investment company, such as commissions for sales of fund shares and brokerage commissions for fund portfolio transactions.

2.159 *Income From Securities.* The auditor should test investment income, which may include testing a sample of dividends and interest earned during the period, applying analytical procedures, or a combination of both. For example, in the auditor's tests of purchases and sales, the auditor may test the income for the entire year from the securities selected or, in conjunction with other procedures, may select an interim period and test the income earned during that period from a representative sample of securities. In testing a sample of dividends for publicly traded securities, the auditor should consult independent financial reporting services to determine the ex-dividend and payable dates and the rates for the securities selected for testing. Interest payment dates and rates are also available from such services.

2.160 In connection with detailed testing, the auditor should consider unusual amounts of dividends (such as dividends in arrears) or interest (such as defaulted interest) received during the period under audit that may require special disclosure. The auditor should be satisfied that the accounting is proper for significant income from noncash dividends. The auditor should test the company's determination of the tax status of dividend income.

2.161 The nature and significance of investment income from sources other than dividends or interest determine the extent of auditing procedures required.

2.162 *Net Asset Value.* The auditor should consider including among the tests of net asset value per share, at the financial statement date and on selected interim dates, tests that—

- Compare with the investment ledger the quantities and descriptions of portfolio securities owned.
- Agree the fair value of investments to independent sources and to supporting documentation for investments stated at fair value, as determined in good faith by the board of directors (or by management under procedures approved by the board of directors).[45]
- Test the clerical accuracy of valuation extensions and totals.
- Reconcile amounts of assets and liabilities to the general ledger accounts. (If it is impractical to post daily in the general ledger, a company may use worksheets instead and, accordingly, the worksheets should be reconciled to the general ledger at the nearest month end or other closing date.)
- Review the reasonableness of income and expense accruals.
- Reconcile the number of shares outstanding to the capital stock accounts in the general ledger or substitute worksheet.
- Calculate the net asset value per share by dividing the difference between total assets and total liabilities by the number of shares outstanding.

2.163 The extent of the auditor's tests of net asset value per share computations depends on, among other factors, the auditor's assessment of control risk.

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[45] In January 2003, the ASB issued Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

In the future, the ASB plans to issue an audit guide that will include guidance on auditing fair value measurements and disclosures relating to specific assets, liabilities, components of equity, or transactions.

2.164 *Valuation of Investments.*[46] For registered investment companies, the auditor should test all portfolio valuations as of the date of the financial statements. (For nonregistered investment companies, the timing and extent of testing portfolio valuations is a matter of the auditor's judgment.) In addition, because periodic computations of net asset value are based on the fair value of investments, the auditor may wish to evaluate the systems and procedures used by the fund during the period under audit in determining the fair value of investments. The auditor should consider testing transactions on dates selected from the period under audit for agreement with the values computed by the company. The extent of those tests should be based on the auditor's judgment and on assessment of control risk.

2.165 The fund's board of directors is responsible for determining the fair value of investments in accordance with the fund's policies. The methods used to value investment securities are usually stated in the bylaws or by action of the board of directors. The methods used by registered investment companies should conform with the 1940 Act. The auditor should determine whether the valuation method used conforms with the company's stated policy and, if applicable, with the rules of regulatory authorities.

2.166 Quoted market prices for investments listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, or NASDAQ. For certain other investments, quoted market prices may be obtained from broker-dealers. If quoted market prices are not available, estimates of fair value frequently can be obtained from third-party sources based on proprietary models or from the investment company based on internally developed or acquired models.

2.167 Quoted market prices obtained from financial publications or from national exchanges and NASDAQ are considered to provide sufficient evidence of the fair value of investments. However for certain investments, such as securities that do not trade regularly, the auditor should consider obtaining estimates of fair value from broker-dealers or other third-party sources. In some situations, the auditor may determine that it is necessary to obtain an estimate of fair value from more than one pricing source. For example, this may be appropriate if a pricing source has a relationship with an entity that might impair its objectivity. The auditor should consider the guidance provided in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*,[47] and SAS No. 101, *Fair Value Measurements and Disclosures*, when auditing the fair value of investments.

2.168 For estimates of fair value obtained from broker-dealers and other third-party sources, the auditor should consider the applicability of the guidance

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[46] In January 2003, the ASB issued Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted. Portions of SAS No. 101 have been incorporated into the guidance contained in paragraphs 2.170 to 2.178.

In the future, the ASB plans to issue an audit guide that will include guidance on auditing fair value measurements and disclosures relating to specific assets, liabilities, components of equity, or transactions.

[47] For guidance on implementing the requirements of SAS No. 92, the reader should refer to the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities.*

in SAS No. 70[48] or SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The auditor's decisions as to whether such guidance is applicable and which guidance is applicable will depend on the circumstances. The guidance in SAS No. 73 may be applicable if the third-party source derives the fair value of a security by using modeling or similar techniques. If an entity uses a pricing service to obtain prices of listed securities in the entity's portfolio, the guidance in SAS No. 70[49] may be appropriate.

2.169 Most fixed income funds use bond dealers or other pricing services to value their portfolios. If such agents are used, the auditor should consider whether controls maintained by the fund or by the pricing service provide reasonable assurance that material pricing errors would be prevented or detected. Such controls may include the following:

- Testing methods used by the pricing service to obtain daily quotations
- Verifying daily changes of each security's fair value in excess of a stipulated percentage
- Verifying dealer quotations with other dealers on a test basis
- Maintaining a comparison of actual sales prices with the fair value assigned for the preceding day
- Consideration of fair value that has not changed for a stipulated period
- Periodic review of pricing information by portfolio managers and other knowledgeable officials

2.170 When investments are valued by the investment company using a valuation model (including an internally developed matrix pricing model), the auditor should obtain an understanding of the entity's process for determining fair value, including:

- Controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between investment management functions and those responsible for undertaking the valuations;
- The expertise and experience of those determining fair value measurements;
- The role of information technology in the valuation process, including the integrity of change controls and security procedures for valuation models and information systems;
- Significant assumptions used in determining fair value, as well as the process used to develop and apply management's assumptions, including whether management used available market information in to develop the assumptions;
- Documentation supporting management's assumptions;
- Controls over the consistency, timeliness, and reliability of data used in valuation models.

The role of the investment company's Board of Directors in establishing valuation policies, and the conformity of the model with those policies and the rules or regulatory authorities should also be considered.

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[48] For more information on SAS No. 70 readers should refer to the Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended,* which includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

[49] See footnote 48.

2.171 It may be possible to test the validity of the model by comparing fair values with values obtained from a second pricing matrix or quotations obtained from market makers. However, as noted in paragraph 2.33, the use of model valuations should be rare when market quotations are available.

2.172 When there are no observable market prices, the auditor should evaluate whether the entity's method of measurement is appropriate in the circumstances. That evaluation requires the use of professional judgment. It also involves obtaining an understanding of management's rationale for selecting a particular valuation method by discussing with management its reasons for selecting that method. The auditor needs to consider whether:

- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided by GAAP to support the selected method;
- The valuation method is appropriate in the circumstances given the nature of the item being valued;
- The valuation method is appropriate in relation to the environment in which the entity operates.

Management may have determined that different valuation methods result in a range of significantly different fair value measurements. In such cases, the auditor should evaluate how the entity has investigated the reasons for these differences in establishing its fair value measurements.

2.173 The auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity. For example, the introduction of an active market for an equity security may indicate that use of a discounted cash flow method to estimate the security's fair value is no longer appropriate. If management has changed the valuation method, the auditor needs to consider whether management can adequately demonstrate that the method to which it has changed provides a more appropriate basis of measurement.

2.174 The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, the auditor needs to evaluate whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency.

2.175 For items valued using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor should assess the reasonableness and appropriateness of the model, including whether management has identified the significant assumptions and factors influencing the measurement of fair value, and whether the significant assumptions used are reasonable and the model is appropriate considering the entity's circumstances. (Significant assumptions cover matters that materially affect the fair value measurement and may include those that are sensitive to variation or uncertainty in amount or nature, and are susceptible to misapplication or bias.) Further, the auditor should determine whether the entity has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments. The auditor should also become familiar with the provisions of the SEC's financial reporting releases on this subject, with emphasis on section 404.03 of SEC's *Codification of Financial Reporting Policies*.

2.176 Specific assumptions used in determining fair value will vary with the characteristics of the item being valued and the valuation approach being used. For example, when an item is valued using discounted cash flows, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate. Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor should evaluate the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information. The evaluation of the assumptions relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent and therefore need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures with respect to management's assumptions is therefore not intended to obtain sufficient competent audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole.

2.177 Events and transactions that occur after the financial reporting date but before completion of fieldwork (for example, a sale of an investment shortly after the financial reporting date), may provide audit evidence regarding management's fair value estimates as of the financial reporting date. In such circumstances, it may become unnecessary to test the fair values determined through a valuation model because the subsequent event or transaction can be used to substantiate the fair value measurement. However, some subsequent events or transactions may reflect changes in circumstances occurring after the financial reporting date and thus do not constitute competent evidence of the fair value measurement at the financial reporting date. The auditor should consider only those events or transactions that reflect circumstances existing at the financial reporting date.

2.178 Collateral often is assigned for certain types of investments in debt instruments that are measured at fair value. If the collateral is an important factor in measuring the fair value of the investment, the auditor should obtain sufficient competent audit evidence regarding the existence, value, rights, and access to or transferability of such collateral, including consideration of whether all appropriate liens have been filed, and consider whether appropriate disclosures about the collateral have been made.

2.179 *Money Market Funds.* For investment companies registered as money market funds as defined in rule 2a-7 of the 1940 Act, the auditor should consider reviewing and performing tests of the following:

- The fund's procedures under rule 2a-7 and the monitoring of those procedures
- Monitoring of the extent of deviation between net asset value per share calculated using amortized cost and net asset value per share calculated using fair value

- Monitoring portfolio maturity, credit quality, and **diversification** requirements of rule 2a-7
- Compliance with recordkeeping requirements of rule 2a-7

Chapter 3

Financial Instruments

3.01 This chapter provides brief descriptions of certain financial instruments of investment companies. Consideration should be given to Financial Accounting Standards Board (FASB) Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,*[*] in connection with accounting and financial statement presentation for these financial instruments.

Money Market Investments

3.02 Short-term investments, such as short-term government obligations, commercial paper, bankers acceptances, and certificates of deposit, may be bought at their face amount or at a discount or premium from their face amount.

3.03 The amortized cost of **money market investments** that mature within a relatively short period (for example, sixty days) usually approximates fair value. However, the impairment of the credit standing of the issuer or unusual changes in interest rates can affect their fair value significantly. In those circumstances, amortized cost may not approximate the fair value of such investments.

Repurchase Agreements

3.04 A repurchase agreement (repo) is, in its simplest form, the purchase of a security at a specified price with an agreement to sell the same or substantially the same security to the same counterparty at a fixed or determinable price at a future date. Because a repo between the two specific parties involved is not transferable, a repo has no ready market.

3.05 Repos are usually entered into with banks, brokers, or dealers. The investment company should always be sure that the repo, including accrued

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[*] On April 30, 2003, the FASB issued FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The Statement amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. This Statement is effective for contracts entered into or modified after June 30, 2003, with certain exceptions as described in FASB Statement No. 149, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. Readers should consider the requirements of FASB Statement No. 149 in addition to the guidance contained in FASB Statement No. 133, as amended, and this Guide.

interest, is fully secured by the fair value of the collateral it has received.[1] The fund's board of directors should evaluate the creditworthiness of the counterparty issuing the repo.[2]

Reverse Repurchase Agreements

3.06 A reverse repurchase agreement (reverse repo or resale) is, in its simplest form, the sale of a security at a specified price with an agreement to purchase the same or substantially the same security from the same counterparty at a fixed or determinable price at a future date. A reverse repurchase agreement allows the investment company to transfer possession of a security to a buyer, usually a broker, for cash. The investment company agrees to repay cash plus interest in exchange for the return of the same securities.

U.S. Government Securities (Treasury Bills, Notes, and Bonds)

3.07 U.S. government securities, known as Treasuries, are negotiable debt obligations of the U.S. government, secured by its full faith and credit and issued at various schedules and maturities. These securities clear through book entry form at the Federal Reserve Bank. The income from Treasury securities is exempt from state and local, but not federal, taxes. U.S. government securities include[3]—

- *Treasury bills*. Short-term securities with maturities of one year or less are issued at a discount from face value. Auctions of 91-day and 182-day bills take place weekly, and the yields are watched closely in the money markets for signs of interest rate trends. Many floating-rate loans and variable-rate mortgages have interest rates tied to these bills. The Treasury also auctions 52-week bills once every four weeks. Treasury bills are issued in minimum denominations of $10,000, with $5,000 increments above $10,000. Individual investors who do not submit a competitive bid are sold bills at the average price of the winning competitive bids. Treasury bills are the primary instrument used by the Federal Reserve in its regulation of the money supply through open market operations.
- *Treasury notes*. Intermediate securities with original maturities of two to ten years. Denominations range from $1,000 to $1 million or more. The notes are sold by cash subscription, in exchange for outstanding or maturing government issues, or at auction.
- *Treasury bonds*. Long-term debt instruments with original maturities of ten years or longer issued in minimum denominations of $1,000.

In addition to these basic security types, the government issues other structures, such as Separate Trading of Registered Interest and Principal of Securities (STRIPSs) also known as stripped Treasury securities and Treasury inflation protected securities (TIPSs).

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[1] Securities and Exchange Commission (SEC) Release No. 10666 under the Investment Company Act of 1940 (the 1940 Act) sets forth the SEC's position that repos should be fully collateralized. That is, "the value of the transferred security . . . is at least equal to the amount of the loan including accrued interest thereon."

[2] SEC Release No. 13005 under the 1940 Act.

[3] Definitions for Treasury bills, notes, and bonds are adapted from the listing under "Treasuries" in Barron's Dictionary of Finance and Investment Terms, fourth edition. Copyright 1995 by Barron's Educational Series, Inc., Hauppauge, NY.

Municipal Notes and Bonds

3.08 Municipal securities are issued by states, cities, and other local government authorities to fund public projects. The interest on these bonds is normally exempt from federal taxes and under certain conditions is exempt from state and local taxes. Municipal notes usually mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenues or on financing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities with payment of principal and interest guaranteed by the U.S. government. Another common municipal note is a variable rate demand note, which is a floating rate instrument with frequent reset coupon rates and usually a put feature.

3.09 Municipal bonds are principally classified as general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its full faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and do not carry the pledge of the issuer's credit. Yields on municipal bonds depend on a variety of factors, including market conditions, maturity date, ratings assigned to the issue, and tax-exempt status. Some municipal bonds may be prerefunded by the issuer whereby the bonds are collateralized by securities or U.S. Treasury obligations. Since many of these are guaranteed by Treasury obligations they often maintain a AAA rating and may trade at a premium over other municipal bonds. Other common municipal bonds include municipal lease obligations, which represent a certificate of participation in the cash flows for certain projects or services, whose funding must be appropriated annually by the municipality.

3.10 Among investment companies, **municipal notes and bonds** are held primarily in the portfolios of both tax-exempt money-market and **municipal bond funds** and require special considerations for valuation. They are traded in a dealer market in which little published price information is available. As a result, new issues of municipal notes or bonds are usually sold by competitive bidding. Subsequent market quotations may be obtained from dealers in those securities.

3.11 A significant decline in the fair value of a municipal security that appears to relate to the issuer's creditworthiness may indicate the probability of default. Comparisons of the fair value of the security with the fair value of similar securities or a downgrading of the issuer's credit rating may indicate such decline.

Insured Portfolios

3.12 Many municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance for the payment of principal and interest when due. The insurance applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to buyers of the securities. That arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the securities and transferable on changes in ownership. If the insurance applies only to the fund's portfolio, it does not have a measurable fair value in the absence of default of the underlying securities or of indications of the probability of default and, accordingly, the cost of the policy should be treated as an operating expense.

When-Issued Securities

3.13 Some securities, principally municipal securities, are traded on a when-issued basis. A municipal securities underwriter solicits expressions of interest in a proposed issue and sends a when-issued price confirmation against which securities are delivered later when the terms of the issue are known. The securities usually begin trading on a when-issued basis on the issuance of the confirmation as if they had been issued a few days before the closing date.

3.14 Securities offerings are rarely aborted after when-issued trading begins. A when-issued security and the obligation to pay for the security should be recorded when the commitment becomes fixed, which is the date on which the priced transaction confirmation is issued. When-issued securities for which the fund has not taken delivery are required to be identified in registered investment company's financial statements.[4] Securities may also be bought on a **delayed delivery contract** under which the underwriter agrees to deliver securities to buyers at later specified dates.

Synthetic Floaters

3.15 Many managers use tax-exempt derivative securities as a way to increase the pool of creditworthy tax-exempt securities. These derivatives include **synthetic floaters**, under which issuers of such instruments use interest payments from long-term municipal bonds, which may be coupled with an interest rate swap and put feature, to pay the floating short-term interest rates. The investor receives regular interest payments that are tied to short-term municipal rates while the issuer earns the spread between the long-term coupon rate and short-term floating rate. The investor may either hold the trust certificate representing ownership of the underlying bond to maturity or put it back to the issuer for cash.

Mortgage Backed Securities (MBSs)

3.16 A **mortgage backed security (MBS)** is a pass-through security created by pooling mortgages and selling interests or participations in the MBS. In some instances the mortgage originator will continue to service the underlying mortgage, or the servicing may be sold to a subsidiary or another institution. Mortgage originators will usually pool mortgage loans and sell interests in the pools created. By selling MBSs, originators can obtain funds to issue new mortgages while retaining the servicing rights on the pooled loans. Most MBSs are guaranteed either by federally sponsored agencies such as the Government National Mortgage Association (GNMA), Fannie Mae (FNMA), Freddie Mac (FHLMC) or by private guarantors. GNMA is a U.S. government owned corporation that approves the issue of MBSs whose principal and interest are then fully guaranteed by the U.S. Treasury. FNMA is a publicly owned, U.S. government-sponsored agency that purchases mortgages, including mortgages backed by the Federal Housing Administration or guaranteed by the Veteran's Administration and other conventional mortgages, and resells them to investors. FREDDIE MAC is a federal agency that issues MBSs known as participation certificates. Although MBSs issued by GNMA are backed by the full faith of the U.S. Treasury, MBSs issued by FNMA and FREDDIE MAC are not directly guaranteed by the

[4] SEC Release No. 10666 under the 1940 Act.

U.S. Treasury. Principal and interest payments received from mortgagors are passed on to the MBS holders forty-five days later for GNMA, fifty-five days later for FNMA, and seventy-five days later for FREDDIE MAC (forty-five days for gold FREDDIE MAC).

3.17 Mortgages are not homogeneous and, as a result, different pools have different prepayment experience. MBSs are considered seasoned once they have been outstanding four to five years. Investors are typically willing to pay more for seasoned mortgages than for unseasoned mortgages because seasoned mortgages have payment experience, which investors use to make estimates of future prepayments. Unseasoned MBSs possess more unknown variables and thus are more sensitive to market volatility.

Adjustable Rate Mortgages (ARMs)

3.18 An **adjustable rate mortgage (ARM)** is a mortgage loan whose interest rate is reset periodically to reflect market rate changes. In addition, ARMs usually have caps that provide borrowers with some protection from rising interest rates. ARMs' interest rates are usually calculated based on one of three indices: (*a*) U.S. Treasury securities, (*b*) cost of funds index, or (*c*) average mortgage rates. Typically, ARM rates are reset every six months, one year, three years, or five years. ARMs are usually priced at a spread above the U.S. Treasury yield and provide the investor some protection against rising interest rates. In addition, GNMA, FNMA, and FREDDIE MAC, or private insurance companies guarantee many ARMs.

Collateralized Mortgage Obligations (CMOs)

3.19 Different kinds of **collateralized mortgage obligation (CMO)** structures exist, each of which has different cash flow characteristics. A security holder may invest in a CMO equity form (for example, trust interests, stock, and partnership interests) or non-equity form (for example, participating debt securities). Some of these structures include the following:

- CMO bonds are bonds collateralized by either a pool of pass-through securities or a pool of mortgage loans and may be issued in several tranches having different maturities and interest rates. The cash flow from the pool of assets is used to pay the principal and interest on the bonds. The sequence of payments is "deal specific" and is modeled by the issuer.
- CMO residuals represent the excess cash flows from MBSs or a pool of loans used as collateral for a CMO bond and include reinvestment income thereon after paying the debt service on the CMO and the related administrative expenses. Most CMO structures have residuals due to the conservative structuring requirements necessary to achieve the highest rating by the rating agency. Cash flows are generated from (a) interest differential between the collateral for the CMOs and the CMO itself; (b) interest differential between the various classes of bonds; (c) reinvestment income; and (d) over-collateralization income. Many different kinds of CMO residuals, including floating-rate residuals, inverse floating residuals (**inverse floaters**, that is, interest rates vary inversely with floating rates), and PAC (principal amortization class) residuals are available.
- Interest-only (IO) and principal-only (PO) securities (also known as strips) are created by splitting a traditional mortgage-backed security or pool of loans into an interest-only portion and a principal-only portion. IO securities may have fixed or variable interest rates. Both IO

and PO securities are subject to prepayments. IO investors are at risk for faster than anticipated prepayments and PO investors for slower than anticipated prepayments. Assumptions regarding the rates of prepayment play a significant role in the price of these securities. As they may not pay a current coupon, prices of IOs and POs are more sensitive to changing interest rates than coupon bonds. They can be stripped from fixed or adjustable-rate loans or a pool of fixed-rate loans containing a range of different mortgage rates. The individual mortgages are subject to prepayment and default risk. PO securities issued by quasi-governmental agencies are usually fully or partially guaranteed against credit loss.

- An IOette is an IO with a relatively low principal amount and high coupon rate. The principal and interest components of MBSs are sometimes separated and recombined in varying proportions to create **synthetic coupon securities**.

Real Estate Mortgage Investment Conduits

3.20 The **real estate mortgage investment conduit (REMIC)** is a form of CMO specially designated for federal income tax purposes so that the related income is taxed only once (to the security holder). A corporation, partnership, association, or trust may elect to be a REMIC and many special purpose entities that issue CMOs, IOs, POs, and MBSs have elected to structure themselves as REMICs.

High-Yield Securities

3.21 High-yield debt securities are corporate and municipal debt securities having a lower than investment grade credit rating (BB+ or lower by Standard & Poor's, or Ba or lower by Moody's). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment grade debt and often have shorter maturities. They are typically unsecured and subordinate to other debt outstanding. Many issuers of high-yield debt securities are highly leveraged with limited equity capital. These inherent differences from **investment grade bonds**, including a market for such securities that may not always be liquid, may increase the market, liquidity, and credit risks of these securities. High-yield debt securities are frequently referred to as **junk bonds**.

3.22 Securities and Exchange Commission (SEC) yield formula calculations are required to be made using the specific guidelines presented in SEC Release No. 33-6753. Yields calculated that way might not be the same as the interest reported in the financial statements. The ultimate realizable value and the potential for early retirement of securities should be considered when computing SEC yields. Management's best estimates of ultimate realizable value must be reasonable. If current values of high yield debt securities decline significantly from the issue price, computed yields may be higher than rates expected to be ultimately realized. To avoid unsound yield information, consideration should be given to capping yields of individual securities at some reasonable level and examining the underlying economic viability of the issuers.

Payment-in-Kind Bonds

3.23 Issuers of **payment-in-kind (PIK) bonds** typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as

baby bonds or bunny bonds. Baby bonds usually have the same terms, including maturity dates and interest rates, as the original bonds (parent PIK bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

3.24 Because PIK bonds possess many characteristics of zero-coupon bonds and because the interest method provides the most analogous accounting treatment, it should be used to determine interest income. PIK bonds typically trade **flat** (that is, interest receivable is included in the price quotation obtained each day). Accordingly, that portion of the quote representing interest income needs to be identified. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable. To the extent that interest income to be received in the form of baby bonds is not expected to be realized, a reserve should be established (that is, it should be determined periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying PIK bond, does not exceed the current fair value of those assets).

Step Bonds

3.25 **Step bonds** are characterized by a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives. Thus, they bear some similarity to zero-coupon bonds and to traditional debentures.

3.26 Income on step bonds should be recognized using the interest method, which is a systematic and rational method for accruing income throughout a bond's life and is not affected by the timing of cash payments. Additionally, to the extent that interest income is not expected to be realized, a reserve should be established. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

Put and Call Options

3.27 An option is a contract giving its owner the right, but not the obligation, to buy (call) or sell (put) a specified item at a fixed price (exercise or strike price) during a specified period (American option) or on a specified date (European option). Options may be exchange traded or over-the-counter. Options may be written on a variety of instruments, indexes, or currencies. The buyer pays a nonrefundable fee (the premium) to the seller (the writer). An investment company may buy or write put and call options, if permitted, as disclosed in the prospectus.[5] As consideration for an option, the buyer pays the writer a premium that is the maximum amount the buyer could lose. That amount is influenced by such factors as the duration of the option, the difference between the exercise price and the fair value of the underlying securities, price volatility, and other characteristics of the underlying securities. In return for the premium—

- A covered writer of a **call option**, a writer who owns the underlying securities, gives up the opportunity to profit from an increase in the fair value of the underlying securities to a point higher than the exercise price of the option outstanding, but retains the risk of loss if the fair value of the securities declines.

[5] Chapter 6 discusses special tax rules.

- An uncovered writer of a call option (a naked option) does not own the underlying securities but assumes the obligation to deliver the underlying securities on exercise of the option. An uncovered writer is exposed to the risk of loss if the fair value of the underlying securities increases above the strike price, but has no risk of loss if the fair value of the underlying securities does not exceed the option exercise price.[6]
- A writer of a **put option** is exposed to the risk of loss if fair value of the underlying securities declines, but profits only to the extent of the premium received if the underlying security increases in value because the holder of the option will not exercise it if the holder can obtain a greater price elsewhere. The writer is covered if a put option is bought on the same underlying securities with an exercise date equal to or earlier than the option it covers and an exercise price equal to or greater than the option written.

3.28 After an option is written, the writer's obligation may be discharged in one of the following ways:

a. The option expires on its stipulated expiration date.

b. The writer enters into a closing transaction.

c. The option holder exercises the right to call (buy) or put (sell) the security (not applicable for **index options**).

3.29 The writer or buyer of an option traded on an exchange can liquidate the position before the exercise of the option by entering into a closing transaction. Such a transaction, in effect, cancels the existing position. The cost of a liquidating purchase, however, may be higher than the premium received for the original option. Because the writer or buyer can enter into a closing transaction, the option originally written may never be exercised. An option traded on an exchange is exercised only through the Options Clearing Corporation (OCC), the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is assigned by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. The clearing broker is obligated to deliver the underlying security against payment of the exercise price. The assigned broker is selected randomly from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

3.30 Most investment companies deposit securities or cash underlying call or put options written in three-party special segregated custody accounts with their custodian and their broker to guarantee delivery or payment if the options are exercised. For options on futures and physical commodities see paragraph 3.37.

3.31 Freestanding written put options and certain contracts which function as market value guarantees on a financial asset that is owned by the guaranteed party, even when classified as derivatives under FASB Statement No. 133, are within the scope of the disclosure provisions of FASB Interpretation No. 45,

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[6] An investment company may be exposed to additional losses resulting from the price appreciation of the underlying security. For registered investment companies section 18 of the 1940 Act provides additional guidance for writers of naked call options. For example, an investment company may mitigate the option's exposure to section 18 prohibitions by segregating cash or other securities in an amount greater than or equal to the option written or by purchasing a call option on the underlying security for similar terms.

Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. Under those provisions, guarantors are required to disclose the following:

a. The nature of the guarantee, including its approximate term, how the guarantee arose, and the events and circumstances that would require the guarantor to perform under the guarantee.

b. The undiscounted maximum potential amount of future payments the guarantor would be required to make under the guarantee, not reduced by any recourse or collateralization provisions.

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee.

d. The nature of any recourse provisions that would enable the guarantor to recover any amounts paid under the guarantee from third parties and any assets held as collateral or by third parties that the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee, together with an indication, if estimable, of the approximate extent to which the maximum potential amount of future payments is covered by liquidating these assets.

These disclosure requirements are effective for financial statements for interim or annual periods ending after December 15, 2002.

Standby Commitments

3.32 A standby commitment is an optional delivery **forward placement commitment contract**. On sale of a standby commitment, an investment company is contractually bound to accept future delivery of a security at a guaranteed price or fixed yield on the exercise of an option held by the other party to the agreement. In effect, the investment company sells a put option and receives a fee for its commitment to buy the security. The investment company bears the risk of loss if interest rates rise, causing the fair value of the security at delivery date to be less than the exercise (strike) price of the option less the fee received.[7]

Commodity and Financial Futures Contracts

3.33 Commodity and financial futures contracts are traded on various exchanges and are thus distinguished from forward contracts, which are entered into privately by the parties.[8] A commodity futures contract is a firm commitment to buy or sell a specified quantity of a specified grade of a specified

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[7] The SEC indicated in Release No. 10666 under the 1940 Act that an investment company's participation in a firm commitment agreement (forward placement commitment or agreement to purchase when-issued securities), standby commitment, or reverse repurchase agreement (repo) may involve the issuance of a security by the investment company. The security may be a senior security as defined in section 18(g) of the Act, and the investment company entering into the agreement may be in violation of section 18(f)(1). However, the Division of Investment Management has determined that it will not raise the issue of compliance with section 18 with the SEC if the investment company covers the senior security by establishing and maintaining certain segregated accounts.

[8] Rule 4.5 under the Commodity Exchange Act generally excludes registered investment companies from the definition of commodity pool operator, and the Commodity Futures Trading Commission (CFTC) release announcing the adoption of the rule indicates that the exclusion also applies to depositors, sponsors, underwriters, and investment advisors. If the exclusion is not applicable, an investment company that trades commodities is subject to regulation by the CFTC as a commodity pool operator, and may also be subject to regulation by the SEC under the Securities Act of 1933 (the 1933 Act). The auditor should become familiar with those regulations as they relate to commodity pool operators.

commodity, or, for financial futures contracts (including index futures contracts), a standardized amount of a deliverable grade security (or a basket[9] for index futures) at a specified price and specified future date unless the contract is closed before the delivery date. For futures contracts, the date is a specified delivery month, and the contract is typically settled by executing an offsetting futures contract before or during the delivery month.

3.34 The quantity and quality provisions of futures contracts are standardized. For example, every cotton futures contract traded on the New York Cotton Exchange is for 50,000 pounds, and every Treasury bill futures contract traded on the International Money Market of the Chicago Mercantile Exchange is for $1 million notional par value.

3.35 Although a confirmation of the trade is submitted showing the pertinent price, quantity, and commodity data, no amount is usually entered in the general ledger. The ledger reflects only the margin deposit and the daily mark to market for variation margin. Details of **open contracts** are in memorandum format. Variation margin normally is settled in cash with the broker each morning for the amount of the previous day's mark to market.

3.36 To initiate a futures contract, the investor is required to make an **initial margin deposit** in an amount established by the various exchanges. This amount varies according to the commodity or security, the prevailing price, whether the investor is speculating or hedging, and market conditions. The initial margin may often be made in Treasury bills. In those cases, the restriction of the ability to trade the Treasury bills should be disclosed in the fund's schedule of investments. Brokers sometimes require margins in excess of those set by the exchanges.

3.37 A registered investment company may use three-party special segregated custody accounts with its custodian bank and each of its futures brokers and deposit initial margin on futures contracts in those segregated custody accounts. Cash or securities deposited to meet margin requirements should be identified as margin deposits on the investment company's records. Alternatively, the investment company may arrange to put up performance bonds or maintain its assets with futures commission merchants (FCMs) that are registered under the Commodity Exchange Act and that are not affiliated with the investment company.[10]

Forward Contracts

3.38 A forward contract is a legal contract between two parties to purchase and sell a specified quantity of a financial instrument at a price specified now, with delivery and settlement at a specified future date. Forward contracts are similar to futures contracts, except that they are not traded on an exchange. Their terms are not standardized, and they can be terminated only by agreement of both parties to the forward contract. If a forward contract is held until expiration, settlement by delivery is required. Most forwards are settled in cash. Forward contracts are entered into directly between two counterparties for future delivery or receipt at a specified price. As a result, they do not settle on a daily basis by margin settlement as do futures contracts. While these contracts can be speculative in nature, a fund typically enters a forward contract to hedge overall portfolio currency risk.

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[9] A group of stocks representing the securities that comprise the underlying index.

[10] See paragraphs 9 through 15 in FASB Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, for further guidance concerning sales of financial assets and pledges of financial assets as collateral.

Foreign Exchange Contracts

3.39 A foreign exchange contract is an agreement between two parties to exchange different currencies at a specified exchange rate at an agreed-upon future date. While these contracts can be speculative in nature, a fund typically enters a foreign exchange contract to hedge overall portfolio currency risk, or to settle foreign security transactions.

3.40 If the purpose of the contract is to hedge portfolio risk, the contract is typically closed by entering into an offsetting contract before the settlement date. In this way, on settlement date the fund is only obligated to deliver or purchase the net amount of foreign currency involved.

Structured Notes or Indexed Securities

3.41 **Structured notes**, sometimes called **indexed securities**, are securities packaged and issued by major financial institutions. The notes have some similar characteristics to a plain debt instrument such as commercial paper, medium-term notes, or certificates of deposit (CDs). Instead of paying a fixed interest rate over time and repaying par at maturity, structured notes index the coupon, the principal, or both to virtually anything with a trading market. The **indexing** may be to currencies, interest rate spreads, stock market indices or the price of a security or commodity completely unrelated to the transaction.

Interest Rate, Currency, and Equity Swaps and Swaptions

3.42 Many variations of swaps exist. Swaps can be linked to any number of underlying instruments and indexes, and swap terms can vary greatly. Trade date is the date of the commitment to enter into the swap. Interest begins accruing on the effective date and cash flows are exchanged, as defined by the agreement.

3.43 Interest rate swaps represent an agreement between counterparties to exchange cash flows based on the difference between two interest rates, applied to a notional principal amount for a specified period. The most common kind of interest rate swap involves the exchange of fixed-rate cash flows for variable-rate cash flows. Interest rate swaps do not involve the exchange of principal between the parties. Interest is paid or received periodically. Swaps range in maturities, usually from one to ten years. Market risk and credit risk are two important risks associated with swaps. Credit risk is often minimized by requiring the counterparty to post collateral if any indication of credit risk exists or by engaging in swaps only with highly rated counterparties. Market risk requires a careful understanding of the effects on the swap's fair value of changing market conditions. Both risks require close monitoring. Swaps may be structured so that the notional principal amount is adjusted up or down during the term of the swap. Floating rate reset periods vary, ranging from daily to yearly.

3.44 A currency swap is an agreement between two parties to exchange two different currencies with an agreement to reverse the exchange at a later date at specified exchange rates. The exchange of currencies at the inception date of the contract takes place at the current spot rate. The reexchange at maturity may take place at the same exchange rate, a specified rate, or the then current spot rate. Interest payments, if applicable, are made between the parties based on interest rates available in the two currencies at the inception of the contract.

The term of currency swap contracts may extend for many years. Currency swaps are usually negotiated with commercial and investment banks. Contracts are subject to risk of default by the counterparty and, depending on their terms, may be subject to exchange rate risk. Some currency swaps may not provide for exchanging principal cash flows, only for exchanging interest cash flows.

3.45 Some funds may enter into equity swaps to manage their exposure to the equity markets. In an equity swap, cash flows are exchanged based on a commitment by one party to pay interest in exchange for a market-linked return based on a notional amount. The market-linked return may include, among other things, the **total return** of a security or index. These agreements involve elements of credit and market risk. Risks include the possibility that no liquid market exists for these obligations, the counterparty may default on its obligation, or unfavorable changes may exist in the security or index underlying the swap.

3.46 A swaption includes any option that gives the buyer the right, but not the obligation, to enter into a swap on a future date. It also includes any option that allows an existing swap to be terminated or extended by one of the counterparties. These structures are also called cancelable, **callable**, or putable swaps. Swaptions can be American, exercisable at any point during the option term, or European, exercisable only on the last day of the option term. Swaptions that establish swaps when exercised may be puts or calls. In both cases, the fixed rate that will be exchanged is established when the swaption is purchased. The term of the swap is also specified. If a call swaption is exercised, the option holder will enter a swap to receive the fixed rate and pay a floating rate in exchange. The exercise of a put would entitle the option holder to pay a fixed rate and receive a floating rate. Calls become more valuable when the underlying securities' prices rise and rates fall. The option holder will exercise a call swaption when rates have fallen from the strike level. The put swaption will be exercised when market rates rise above the fixed rate the option holder can pay (that is, prices have fallen).

Short Positions

3.47 A short sale creates a senior security for registered investment companies that is subject to the limitation of section 18 of the Investment Company Act of 1940 (the 1940 Act). To comply with the provisions of section 18, a registered investment company that sells securities short must establish a segregated account, as discussed in the section on accounting for segregated accounts, to account for cash or cash equivalents equal in fair value to the securities sold short or to equivalent securities already owned if the sale is **against the box**.

Mortgage Dollar Rolls

3.48 Mortgage dollar rolls (MDRs) are documented as agreements to sell and repurchase substantially similar but not identical securities.[11] Dollar rolls differ from regular reverse repo agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts. The most common kinds of dollar rolls are fixed-coupon and yield-maintenance arrangements.

[11] See SEC Release No. IC-22389 dated December 11, 1996.

3.49 The investment company and the counterparty may decide to extend the contract and not return the securities involved in the roll. The contract may be extended in this manner over a number of periods with the agreement of both counterparties.

3.50 An MDR can also be executed entirely in the to-be-announced (**TBA**) market, where the investment company makes a forward commitment to purchase a security and, instead of accepting delivery, the position is offset by a sale of the security with a simultaneous agreement to repurchase in the future.

3.51 Compensation to the investment company for the risks involved in an MDR transaction is in the form of either (*a*) a fee or (*b*) a reduction in the repurchase price of the security, referred to as the drop.

Chapter 4
Capital Accounts

4.01 This chapter deals primarily with operations, controls, and accounting and auditing matters affecting the capital accounts of open-end investment companies (also known as mutual funds). Among the regulations and limitations that affect the accounting for capital stock transactions of open-end investment companies are the following:

- Rule 2a-4 and 12b-1 of the Investment Company Act of 1940 (the 1940 Act)
- National Association of Securities Dealers, Inc. (NASD) limits on sales charges
- Load structures and arrangements for reduced sales charges as established in fund prospectuses
- Rule 18f-3 of the 1940 Act and exemptive orders in effect for individual fund complexes relating to multiple classes of shares

Most transactions affecting the capital accounts of closed-end investment companies can be accounted for and audited similarly to other commercial enterprises.

Operations and Controls

Distributors

4.02 As stated in chapter 1, many open-end investment companies enter into agreements with a separate distributor (also called an underwriter) under which the distributor obtains the exclusive right, as either principal or agent for the fund, to deal in fund shares as a wholesaler, reselling the shares to independent dealers or through its own sales network. Commonly, the distributor is an affiliate of the fund sponsor.

4.03 How distributors are compensated depends on the kind of arrangement that applies to the shares that they are selling. A commission or sales charge may be assessed on mutual fund investments when the shares are purchased (at the front end), when the shares are redeemed (at the back end), or during the period the shares are held by a shareholder (level-load). Fund shares sold through full-service distribution channels, such as brokers or financial planners, typically include a sales charge or fee of some sort in exchange for providing additional investment advice or services.

4.04 When shares with a front-end load are distributed through independent dealers, a significant portion of the load (or commission) is retained by the independent dealer for its services (including payment of a commission to the broker actually selling the shares) and the remainder is remitted to the distributor. The distributor retains the full front-end load when its own sales network is responsible for selling shares, but pays commissions to its employees out of the load. When shares with a back-end load, typically known as a **contingent deferred sales charge (CDSC)** or contingent deferred sales load (CDSL), are sold, no commission is subtracted from the proceeds received from the investor. Instead, the distributor pays the commission to the independent dealer or its employees. Other installment or non contingent deferred sales loads may be applied that do not decline to zero, as well as loads paid after purchase during the shareholder's time in the fund.[1]

4.05 Sales commission rates on mutual funds with front-end loads typically decline as the amount of the sale increases. Some funds offer various arrangements, including **letters of intent** and **rights of accumulation**, entitling individual purchasers to reduced sales charges based on aggregate purchases of shares of either the individual fund or funds within the same mutual fund complex. Also, front-end loads may either be reduced or waived when shares are sold under employee benefit arrangements such as **401(k) plans**.

4.06 Rule 12b-1 (under the 1940 Act) fees generated by the sale of level-load shares are typically used to compensate dealers and sales personnel for their selling and servicing efforts. CDSC shares are typically offered in combination with a rule 12b-1 distribution plan, under which the fund makes payments to the distributor for distribution services. The distributor typically uses 12b-1 payments and CDSC receipts to recover the initial commission that it paid for sales of CDSC shares. The amount of payments a fund may make for this purpose is capped under NASD rules.[2]

4.07 Some funds offer both front-end load and back-end load shares, including shares with different sales charges, to retail and institutional investors by issuing multiple classes of shares, each with different load structures and distribution fees. To issue multiple classes of shares, most fund groups obtained individual exemptive orders from the Securities and Exchange Commission (SEC) until rule 18f-3, which provides standard conditions under which multiple classes of shares may be offered, was issued in 1995. Some funds with unique variations have elected not to adopt the provisions of rule 18f-3 and continue to rely on their individual exemptive orders. Because discounts typically are not provided on sales commissions for back-end load shares, multiple class funds may limit the dollar amount that may be invested by a retail investor in back-end load shares and require those orders over a certain amount to be treated as orders for front-end load shares. Chapter 5 contains a more comprehensive discussion of multiple classes of shares.

Orders to Purchase or Redeem

4.08 Investors buy at an **offering price**, which, for front-end load funds, consists of the net asset value received by the fund plus a sales charge received by the principal underwriter, and in some instances may include a purchase premium, which to the extent received by the fund, is credited to capital. Investors redeem shares at net asset value although, in some instances, a fund may charge **redemption fees**, which, to the extent received by the fund, are credited to capital. Orders accepted by the fund or its agent are executed at prices based on the net asset value per share that is first computed after the

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[1] Securities and Exchange Commission (SEC) Release No. IC-22202 (September 9, 1996).

[2] Under the "maximum sales charge rule" in the National Association of Securities Dealers, Inc. (NASD) Rules of Fair Practice, no member may offer or sell shares of any open-end investment company registered under the Investment Company Act of 1940 (the 1940 Act) if the public offering price includes a sales charge which is excessive. Under existing rules, the maximum front-end sales charge may not exceed 8.5 percent of the offering price of mutual fund shares. The maximum amount is scaled down in steps to 6.25 percent if investors are not offered one of three additional services or benefits: dividend reinvestment at net asset value, quantity discounts, or rights of accumulation. Further, asset-based sales charges specifically exclude service fees. Service fees are defined as payments by an investment company for personal service or the maintenance of shareholder accounts or both.

order is accepted (**forward pricing**) and are time-stamped when received to substantiate the price.[3] Most funds price their shares once a day, but some do so more often. Confirmations of share transactions are sent to investors. Funds have adopted a variety of ways for shareholders to redeem their shares, including the use of debit cards, automatic teller machines, check writing, wire orders, and telephone **redemption** procedures. Some funds have established Internet Web sites that permit shareholders to conduct transactions in fund shares electronically. The auditor should become acquainted with the particular redemption methods described in the fund's prospectus.

4.09 Accurate recording of sales and redemptions of fund shares depends on the adequacy of the distributor's, the fund's, and the transfer agent's controls over order processing. The accuracy of the information on the order tickets about the investor, the number of shares, and dollar amount depends mainly on the reliability of the distributor's information. The processing of sales and redemptions depends on the integration of a variety of systems that gather and disperse information. The key element of control used when capturing such information to be recorded on the fund's books and records is the daily balancing of net dollars received or paid by the fund with net shares issued or redeemed. The daily reconciliation of cash flows, capital stock receivables and payables, and capital shares outstanding between the fund's accounts and those of the transfer agent and subtransfer agent (if applicable) helps the maintenance of accurate capital accounts.

4.10 Certain kinds of funds (such as money market funds) may sell or redeem a large volume of shares in response to market volatility. The transfer agent's controls over such activities as check writing, wire transfers, and telephone redemptions should be adequate to support periods of heavy volume.

4.11 The fund is responsible for establishing criteria for honoring redemptions. For redemptions made within a prescribed number of days of a purchase by personal check, funds usually do not remit redemption proceeds until they can be assured that the purchase check has cleared. This remittance delay (generally) does not apply to purchases made by wire transfer. Funds usually do not honor redemptions unless purchases by personal check were made a prescribed number of days before redemption or purchases were made by federal funds. Control procedures should provide for identification, for all accounts, of amounts and dates of purchases by personal checks.

4.12 Capital account data are recorded in sales journals, redemption journals, distribution records, and outstanding share records. Also, to meet SEC disclosure requirements and state **Blue Sky laws**, the sales journal may contain the source of the order by dealer (primarily load funds), sales statistics by geographic area, the size of the order, and other share data.

Cancellation of Orders

4.13 A purchase or redemption may occasionally be canceled by an investor or broker-dealer before the settlement date. A change in net asset value per share between the original sales date and the date of cancellation or correction results in a gain or loss to the fund. If a distributor is involved and cancellation results in a loss, the distributor may bear the loss or collect cash from the broker-dealer in the amount of the loss. If the cancellation results in a gain, the distributor may accumulate the gain to offset losses from future cancellations and periodically settle the net losses with the fund. If no distributor is involved, the fund should consider refusing to accept sales orders not accompanied by

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[3] Rules 2a-4 and 22c-1 under the 1940 Act.

payment, unless a responsible person has indemnified the fund for the failure to pay. Except for preauthorized expedited redemption procedures, the fund should also consider accepting orders for redemptions only if the stock certificates or written requests for book shares are properly endorsed and the signatures guaranteed by an appropriate organization, unless indemnified by a responsible person against failure to complete the transaction.

Shareholder Transactions

4.14 Because of the continuous sales and redemptions of open-end fund shares, shareholder transactions are an integral part of a mutual fund's operations and are more complex than stock transfers of usual commercial entities. The records for total shares outstanding, total shares issued, and detailed shareholder accounts are kept current on a daily basis. Specialized procedures, controls, and systems are required to maintain adequate shareholder records and comply with a variety of federal and state regulations governing such records. Although mutual fund shares may be processed by an in-house operation (an **affiliated company** of the fund's manager or distributor), an independent transfer agent is often employed to perform this function. The basic operations of all funds are the same; however, the methods used by funds to control stock transfers vary depending on the distribution channel, load structure, and role of the transfer agent in distributing the fund.

4.15 The transfer agent maintains a separate account for each shareholder and performs the detailed recordkeeping associated with sales, redemptions, distributions, and reinvestments within the account plus preparing and mailing shareholder communications. Accounts may also be maintained on an omnibus level, in which case a separate entity (subtransfer agent, broker-dealer, or plan administrator) performs the detailed subaccounting by shareholder. A fund and its distributor depend on information provided by the transfer agent's daily statement to record sales and redemption orders sent by investors directly to a transfer agent. The transfer agent's daily statements show the day's activity both in shares and dollars and should be reconciled to the fund's records to promptly identify and satisfactorily account for differences. A significant difference in the number of shares outstanding between the transfer agent's and the fund's records could affect net asset value per share.

4.16 Cash used to settle transactions received by the fund, its distributor, or its transfer agent is forwarded to the custodian bank. Cash for redemptions is usually disbursed by the transfer agent to the investor or broker-dealer. Under arrangements in which the distributor and the fund do not handle cash, the fund depends on the transfer agent to provide information on paid and unpaid sales and redemptions. Sales of stock and redemptions are usually settled within three business days. Either the transfer agent, distributor, or the fund administrator, depending on the arrangement, follows up on delinquent accounts receivable and unpaid redemption orders.

4.17 A shareholder in an investment company usually chooses to receive distributions from net investment income and net realized gains from securities transactions in cash or in additional capital shares. Such payments or issuances of shares are usually made by the transfer agent. Internal Revenue Service regulations may require tax withholding on certain distributions. Besides distributing cash or shares, the transfer agent is responsible for preparing and mailing annual tax notices to all shareholders about the amount and character of distributions paid. To be sure that appropriate information is communicated to shareholders, the fund should transmit such information to the transfer agent on a timely basis.

4.18 Money market funds and some fixed income funds declare and accumulate distributions daily for each account and usually distribute them in cash or additional shares monthly. The fund or its transfer agent mails periodic confirmation statements to the shareholders showing the cash distribution or additional shares credited to the account.

4.19 Accounting for treasury stock may be significant for commercial entities and for certain closed-end investment companies. It is less important to mutual funds because only the total number of shares outstanding is relevant in their financial statements, and the number of shares previously redeemed by a fund is important only in connection with certain requirements of regulatory authorities. The SEC and state authorities have varying requirements for registration of shares sold in their respective jurisdictions. Sections 24e and 24f of the 1940 Act permit retroactive registration, under the Securities Act of 1933 (the 1933 Act), of shares sold in excess of shares registered, and permit registration of an indefinite number of shares. A fund therefore needs to keep adequate records of the number of shares registered and the number and dollar amounts of shares sold in various jurisdictions. It also needs to make the required filings within the time permitted under regulatory statutes.

4.20 The 1940 Act and the Securities Exchange Act of 1934 (the 1934 Act) specify certain recordkeeping requirements for funds and transfer agents, respectively. The SEC's staff periodically inspect the records for compliance.

4.21 The fund should determine that the number of outstanding shares shown on the fund's general ledger and the transfer agent's shareholder control ledger and master security holder file[4] agree, and that the detailed shareholder accounts are posted currently. Items that require close attention include transactions in the shareholder control ledger and master security holder file not yet applied to the detailed shareholder accounts and errors in posting to individual shareholder accounts, including postings to incorrect accounts. In addition to these and other similar monitoring activities, the fund may find it necessary to periodically review the transfer agency operation on site. The review often includes an inspection of the files containing shareholders' correspondence and inquiries; these files must be maintained by the company or its transfer agent. A significant volume of complaint letters may indicate problems in the detailed shareholder accounts. The fund should also obtain a copy of any service auditor's report on controls at the transfer agent. Guidance on the use of a service auditor's report is provided in Statement on Auditing Standards (SAS) No. 70, *Service Organizations*[5] (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

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[4] Shareholder control ledger and master security holder file are defined in rule 17Ad-9 of the Securities Exchange Act of 1934. These files are commonly referred to as supersheets for open-end investment companies.

[5] In September of 2002, the Auditing Standards Board (ASB) issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Among other things, SAS No. 98 amends SAS No. 70, *Service Organizations* (AU sec. 324.57–.60), to require a service auditor to inquire of management about subsequent events. The previous guidance, in Auditing Interpretation No. 6 of SAS No. 70, stated that a service auditor should *consider* inquiring of management about subsequent events. SAS No. 98 also rescinds Auditing Interpretation No. 6 of SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003. Earlier application is permissible.

For more information on SAS No. 70 readers should refer to the Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended,* which includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

Accounting for Capital Share Transactions and Distributions

4.22 Accounting for shareholder transactions of open-end funds differs from the accounting followed by commercial entities in several key aspects. Sales of fund shares are recorded daily by crediting capital stock for the par value of the stock to be issued and additional paid-in capital for the amount paid over the par value; redemptions are recorded daily by debiting those accounts. The offsetting debit (credit), however, is made to an asset (liability) account, typically captioned "receivable for fund shares sold" ("payable for fund shares redeemed"). These entries are made on or as of the date the order to purchase or sell fund shares is received (trade date), not on the day that the payment is due (settlement date) as is typical practice for the recording of issuance of equity shares by commercial entities. Investment partnerships should record capital subscription and redemption commitments as of the date required by the partnership agreement. Cash received before this date should be recorded as an advance capital contribution liability.

4.23 For multiple classes of shares, capital accounts are maintained by class and the transfer agent provides separate share activity that is recorded as above on a class-specific basis. Feeder funds within a master-feeder structure account for their capital share activity like typical single-tier funds. If the master fund is a partnership, no capital share transactions are recorded at the master level. Instead, contributions and withdrawals of the various feeders are recorded by the master fund.

4.24 Investment income and realized gains on securities transactions and their distributions are usually accumulated in separate accounts. Proper recording of distributions depends on, among other things, proper recording of the number of outstanding shares. Multiple class funds require specialized earnings allocation and distribution practices as described in chapter 5.

4.25 Both closed-end and open-end investment companies record distribution liabilities on the ex-dividend date rather than the declaration date. For closed-end companies, a purchaser typically is not entitled to a dividend for shares purchased on the ex-dividend date. Open-end companies record the liability on the ex-dividend date to properly state the net asset value at which sales and redemptions are made. When large (in excess of 15 percent of a closed-end fund's net asset value, according to New York Stock Exchange requirements, rule 703.02 of the *Listed Company Manual*) dividends or distributions are declared, it is the policy of some exchanges to postpone the ex-dividend date until the dividend has been paid. In such circumstances, the liability for the dividend distribution would be recorded on the books of the fund on the payment date.

4.26 Shareholders of investment companies that offer the right to reinvest distributions—that is, receive distributions in additional shares—usually notify the company at the time they make their first purchase of shares of their intention to accept cash or to reinvest future distributions. An investment company establishes a policy regarding the date for reinvestment of distributions (the reinvestment date), which is typically the same as, or the day after, the ex-dividend date. For both closed-end and open-end funds issuing shares on reinvestment, the reinvestment date is the date at which the issuance of additional shares must be recognized in the accounts. Although the payment date is significant to those receiving the distribution in cash, the reinvestment date is important to those electing to reinvest the distribution in additional shares. At the reinvestment date, the actual or, if necessary, estimated number of shares to be issued and the price per share for reinvestment are set using the ex-dividend date's net asset value per share. The total net assets reflect the total dollars reinvested and the additional shares outstanding resulting from the distribution reinvestment. At reinvestment date, both shares and dollars show effect of the reinvested dividends. Pursuant to a dividend reinvestment plan, a closed-end fund may be required to purchase shares in the open market when the fund's market price per share is less than the net asset value per share.

Equalization

4.27 Certain open-end investment companies use the accounting practice of **equalization**, which is unique to their industry. The practice was adopted in the 1930s to try to keep the continuing shareholders' interest in undistributed income from being affected by changes in the number of shares outstanding by applying a portion of the proceeds from sales and costs of repurchases of capital shares to undistributed income.

4.28 The equalization theory states that the net asset value of each share of capital stock sold or repurchased comprises the par value of the stock, undistributed income, and paid-in and other surplus. When shares are sold or repurchased, the investment company calculates the amount of undistributed income available for distribution to its shareholders and, based on the number of shares outstanding, determines the amount associated with each share. The per share amount so determined is credited to the equalization account when shares are sold and is charged to the equalization account when shares are repurchased.

4.29 Registered investment companies using equalization accounting should disclose net equalization debits or credits in the statement of changes in net assets as required by rule 6.09.2 of Regulation S-X.

Auditing Procedures

Principal Audit Objectives

4.30 The tests of the capital accounts (shareholder accounting) of a mutual fund cover a broad area encompassing various aspects of transactions with shareholders. The principal audit objectives are to make sure that—

- The number of outstanding shares of capital stock at the audit date is stated properly.
- Procedures are satisfactory for determining the number of outstanding shares used to compute daily net asset value per share.
- Procedures are satisfactory for determining the number of shares required to be registered under the 1933 Act.
- The receivable for capital stock sold and the payable for capital stock redeemed are stated properly.
- Distributions from investment income, net realized gains from securities transactions and capital, and their reinvestments, if any, are computed and accounted for properly.
- Procedures are satisfactory for maintaining control over the recordkeeping for individual shareholder accounts.

Consideration of Internal Control

4.31 The auditor should become familiar with the following:

- The rules and regulations under the 1940 Act and under section 17 of the 1934 Act that encompass shareholder accounting, including pricing of fund shares, recordkeeping requirements, and applicable exemptive orders

- The fund's current prospectus, which states the fund's policies for accepting sales orders and redemption of fund shares

The agreement among the fund, its distributor, and those responsible for the stock transfer function

- State Blue Sky laws, NASD rules, and the fund's procedures for monitoring compliance

4.32 The auditor should understand the shareholder accounting and transfer function, whether performed by the fund or outside agents. (See the discussion in paragraphs 4.53 through 4.58 on reports on controls at outside service organizations.) The auditor should consider the controls over processing of the following:

- Sales
- Redemptions
- Reinvestments
- Cash distributions
- Correspondence
- Stock issuance and stock dividends
- Letters of intent
- Transactions subject to rights of accumulation
- Collections on sales and repayments for redemptions
- Cancellation of sales and redemptions
- Check writing and telephone redemptions
- Account maintenance (address, name, dividend option, and so on) changes
- Inactive accounts (for example, dormant or undeliverable accounts)

4.33 If the procedures for the above are implemented properly, the fund or its agent would be furnished promptly with the information required to process properly its shareholder records as required by the 1940 Act.

4.34 Administrative arrangements providing for such services as sub-transfer agency and recordkeeping may exist among the fund, its custodian, transfer agent, or underwriter. The auditor should review the contractual responsibilities of the various parties to those arrangements to determine whether to—

- Obtain information about the controls of those parties that may affect the investment company's information technology.[6]
- Obtain a service auditor's report on controls at service organizations that may affect the investment company's information technology.
- Perform other procedures.

4.35 Based on an understanding of internal control, and controls at service organizations, if applicable, the auditor may decide to obtain evidential matter about the effectiveness of both the design and operation of controls to

[6] Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, and by SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the aspects of an entity's information technology that are relevant to an audit of financial statements.

reduce the assessed level of control risk below the maximum level. Such evidential matter may be obtained from tests of controls or from procedures that were not specifically planned as test of controls but that nevertheless provide evidential matter about the effectiveness of the design and operation of the controls.

4.36 The auditor may select transactions throughout the audit period to test controls in some of the following areas:

- Pricing shares at net asset values next computed
- Review and approval of daily transaction totals
- **As-of transactions**
- Reprocessed transactions

After identifying specific controls relevant to specific assertions and performing tests of these controls, the auditor should evaluate evidential matter obtained through the testing and conclude on the assessed level of control risk. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests to be performed.

4.37 The auditor may wish to review schedules maintained by the fund of sales of shares in each state concerning Blue Sky laws and federal regulations to test compliance with regulatory requirements or to determine that management is monitoring such compliance.

Examination of Transactions and Detail Records

4.38 The auditor performs substantive tests of activity and balances in the capital accounts based on many factors, including the assessed level of control risk.

4.39 *Sales and Redemptions of Fund Shares.* The auditor may wish to test whether details on the order form or other customer evidence used in processing a sale or redemption agree with the copy of the form ultimately sent to the shareholder to confirm the sale or redemption. Such tests should also determine whether the transactions conform with the fund's prospectus (including sales charges) and with the reinvestment and redemption options selected by the shareholder in his or her account application.

4.40 Depending on the method used to redeem shares, the auditor may examine shareholder requests, wire order forms, telephone tape recordings, telephone order forms, and copies of checks remitted to shareholders.

4.41 The auditor should test totals of daily sales, and redemptions of capital shares by comparing them with postings in the related journals. Capital stock outstanding for the days tested should be compared against the applicable daily net asset valuation worksheets used as the basis for computing the net asset value per share.

4.42 *Settlement of Sales and Redemption Transactions.* The auditor should gain assurance that procedures are in place to determine that receivables for shares sold and payables for shares redeemed are priced and settled promptly. Subsidiary trial balances of receivables and payables should be reconciled with general ledger control accounts as of the balance sheet date. The timely cancellation of sales and redemptions not settled within a specified time and the disposition of losses that may result should also be determined.

4.43 *Reconciliation of Shares Outstanding.* The auditor should become satisfied that the fund has reconciled its general ledger account for outstanding shares with reports of the transfer agent throughout the audit period and satisfactorily resolved all reconciling items. The auditor should examine the underlying support for the reconciling items to the extent considered necessary.

4.44 At the balance sheet date, the auditor should confirm shares outstanding directly with the transfer agent and should determine whether the shares have been reconciled with the shares shown as outstanding in the fund's records. Should the auditor conclude that audit risk has not been reduced to an acceptably low level by the combination of obtaining an understanding of the control environment (including consideration of any related service auditor's report) and confirming shares outstanding in total with the transfer agent, the auditor may consider it desirable or necessary to confirm outstanding shares directly with shareholders. The auditor may perform the confirmation procedure at a date other than the balance sheet date. For example, the auditor may confirm the shares outstanding at the interim date of the audit.

4.45 *Dividends and Distributions to Shareholders and Reinvestments.* Payments of dividends on capital stock may be tested to determine that payments in cash or in additional capital stock have been computed properly. Distributions based on long-term realized gains from securities transactions, except for a supplemental distribution of up to 10 percent of the original distribution, may not be paid more than once a year by a registered investment company except that an additional distribution of long-term gains may be made solely to comply with Internal Revenue Code distribution requirements under excise tax regulations. However, pursuant to rule 19b-1(e) of the 1940 Act, a fund may apply to the SEC for permission to make an additional distribution(s) of long-term capital gains.

4.46 The auditor should review the board of directors' minutes for relevant dates and amounts of dividend declarations and should test whether shares outstanding on that date (ex-dividend date for open-end companies), according to the fund's records, have been reconciled to information reported by the transfer agent. The total dividend should be recomputed (outstanding shares times rate) and compared against a notification from the dividend-paying agent, who is usually also the transfer agent. To test that the liability for a dividend was recorded on the proper date, the dividend should be compared with the general ledger and with the applicable daily net asset valuation worksheet. The computation of the number of shares to be reinvested, as reported by the dividend-paying agent, should be tested, and the portion of the dividend taken in shares should be compared against the capital stock accounts for agreement of both number of shares and dollar amounts.

4.47 The computations of daily dividend rates for funds that declare dividends daily should be tested for selected dates throughout the period.

4.48 *Recordkeeping for Individual Shareholder Accounts.* Based on the assessed level of control risk for assertions that relate to the activities of the transfer agent or shareholder servicing agent, the auditor may wish to select some accounts to test the validity and proper documentation of transactions for name and address changes, share transfers to or from individual accounts, and transactions that are not routine. The auditor may find it desirable to confirm some shareholder accounts, such as for a transfer agent that is not independent of the investment company or where the auditor cannot rely on the transfer agent's controls.

Other Matters

4.49 If equalization accounting is used, the auditor may test the calculation of equalization amounts.

4.50 Correspondence from shareholders received by the fund or transfer agent should be reviewed on a test basis. A significant volume of complaints relating to pricing or incorrect calculations of shares issued may suggest to the auditor that additional testing may be necessary.

4.51 The auditor may wish to confirm balances receivable for capital stock and balances payable for capital shares to be redeemed by the fund directly with the investor or the dealers who sell the fund's shares. Details of specific capital stock transactions may also be confirmed. Alternative auditing procedures may also be used to satisfy the auditor concerning receivables and payables for fund shares sold and redeemed.

4.52 Management's representation letter should state that fund shares were sold and redeemed in accordance with the fund's prospectus, the SEC's rules and regulations, and state securities regulations. For funds with multiple classes of shares, the auditor should become satisfied that the fund has allocated its daily activities among each respective class of shares, based upon the method chosen (see chapter 5), and properly calculated its net asset values throughout the period. The auditor should examine the allocations and their underlying support, including records of shares outstanding. In addition, the auditor should determine that class-level fee waivers and reimbursements were not in violation of rule 18f-3 under the 1940 Act or any related SEC exemptive orders. The auditor should also consider possible implications of any waivers on the fund's distributions under the Internal Revenue Code (see chapter 6).

Reports on Controls at Outside Service Organizations[7]

4.53 When a fund uses a service organization, such as an outside transfer agent, subtransfer agent, or recordkeeping agent, transactions that affect the fund's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the fund. The significance of the controls of the service organization to those of the fund depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the fund and the degree of interaction between its activities and those of the fund. For example, if the fund initiates transactions and the service organization executes and does the accounting processing of those transactions, there is a high degree of interaction between the activities of the fund and those at the service organization. In these circumstances, it may be practicable for the user organization to implement effective controls over those transactions. However, if the service organization initiates, executes, and does the accounting processing of the user organization's transactions,

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[7] In September of 2002, the Auditing Standards Board (ASB) issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Among other things, SAS No. 98 amends SAS No. 70, *Service Organizations* (AU sec. 324.57–.60), to require a service auditor to inquire of management about subsequent events. The previous guidance, in Auditing Interpretation No. 6 of SAS No. 70, stated that a service auditor should consider inquiring of management about subsequent events. SAS No. 98 also rescinds Auditing Interpretation No. 6 of SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003. Earlier application is permissible.

For more information on SAS No. 70 readers should refer to the Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*, which includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

there is a lower degree of interaction, and it may not be practicable for the fund to implement effective internal controls over those transactions.

4.54 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, and by SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), states that an auditor should obtain an understanding of an entity's internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT)[8] and manual procedures may affect controls relevant to the audit. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. If a fund uses a service organization, certain controls and records of the service organization may be relevant to the fund's ability to record, process, summarize, and report financial data in a manner consistent with the assertions in the entity's financial statements. Paragraphs .03 through .10 of SAS No. 70 describe factors that an auditor should consider in determining whether to obtain information about controls at a service organization.

4.55 The auditor uses his or her understanding of internal control to assess control risk for the assertions embodied in the account balances and classes of transactions, including those affected by the activities of the service organizations. SAS No. 70 provides guidance on the auditor's assessment of control risk in such circumstances. SAS No. 70 states that, if the auditor plans to assess control risk below the maximum for assertions that are affected by activities of the service organization, the auditor should evaluate the operating effectiveness of controls at the service organization relevant to those assertions by obtaining a service auditor's report on the controls placed in operation and tests of operating effectiveness, obtaining an agreed-upon procedures report that addresses those controls, or performing tests of controls at the service organization.

4.56 Although a service auditor's report on controls placed in operation and tests of operating effectiveness may provide a basis for assessing control risk below the maximum, it does not permit the auditor to assess the level of control risk so low as to eliminate the need to perform substantive tests for the fund's capital accounts and transactions.

4.57 SAS No. 70 provides guidance on the auditor's considerations in using a service auditor's report. To evaluate a service auditor's report, the auditor should follow that guidance. The auditor may wish to discuss with the service auditor the scope and results of the service auditor's work for a better understanding of the procedures and conclusions.

4.58 The auditor should not refer to the report of the service auditor as a basis, in part, for an opinion on the fund's financial statements. The service auditor's report is used in the audit, but the service auditor is not responsible for examining any portion of the financial statements as of any specific date or for any specific period.

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[8] Information technology (IT) encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices. An entity's use of IT may be extensive; however, the auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data.

Chapter 5

*Complex Capital Structures**

5.01 Many investment companies adopt complex capital structures to increase flexibility in pricing and access to alternative distribution channels for their shares. Such structures are principally of two kinds: multiple-class funds and master-feeder funds. In addition, many organizations are offering funds of funds, which are discussed later in this chapter.

5.02 Multiple-class funds issue more than one class of shares. Each class of shares typically has a different kind of sales charge, such as a front-end load, contingent-deferred sales load, 12b-1 fee, or combinations thereof. Multiple-class funds may charge different classes of shares for specific or incremental expenses, such as transfer-agent, registration, and printing expenses related to each class.

5.03 A commonly used multiple-class structure includes (but is not limited to) the following classes of shares:

- *Class A.* Class A shares are charged primarily a front-end sales load. (The shares might also be assessed a low 12b-1 or service fee.)
- *Class B.* Class B shares bear a contingent deferred sales charge (CDSC) coupled with a 12b-1 distribution or service fee. Class B shares often convert to Class A shares at a specified future date so as to avoid being assessed a higher 12b-1 fee for an extended period.
- *Class C.* Class C shares bear a level sales load, typically a 12b-1 distribution or service fee similar to the level charged in Class B. Class C shares usually have a 1 percent CDSC assessed for one year. There is usually no conversion to another class.
- *Institutional shares.* Shares typically bear no sales load and usually do not have 12b-1 distribution charges. There may be a service fee depending upon the source of the shares, whether they are sold through wrap programs or trust departments. Such selling agents often have their own structures that charge the fee directly to the investor.

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* In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, an interpretation of ARB No. 51. Until the issuance of this Interpretation, investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. FASB Interpretation No. 46 would change the model for determining when to consolidate a controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. The Interpretation would also require disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company. In August 2003, the FASB Board has directed the FASB staff to issue a FASB Staff Position delaying the effective date of FASB Interpretation No. 46 for investment companies not subject to SEC Regulation S-X, Rule 6-03(c)(1) that are currently accounting for their investments in accordance with the specialized accounting guidance in this Guide. The deferral would not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity. The FASB Board decided to delay the effective date for these parties while the AICPA finalizes its proposed SOP on the clarification of the scope of this Guide and accounting by the parent companies and equity method investors for investments in investment companies. When the AICPA issues the final SOP, the FASB Board will consider modifying paragraph 4(e) of FASB Interpretation No. 46 to provide an exception for companies that apply the Guide as revised by the SOP. Readers should be alert for additional action by the FASB and the ultimate impact FASB Interpretation No. 46 may have on non-registered investment companies.

5.04 Although no legal requirements exist regarding specific class designations, many in the industry have adopted the above nomenclature voluntarily to avoid shareholder and sales force confusion.

5.05 In master-feeder structures, separate investment companies often perform the investment management and distribution functions. Feeder investment companies, each having similar investment objectives but different distribution channels for their shares (such as retail or institutional customers), invest their assets solely in another investment company, known as the master fund. All investment management functions are conducted by a master fund, whereas distribution, shareholder-servicing, and transfer agent functions are conducted by the feeders.

5.06 The master fund is generally organized as a trust, with attributes that qualify it as a partnership for tax purposes, and registered under the Investment Company Act of 1940 (the 1940 Act). Feeders are generally organized as corporations or trusts, may be taxed under the Internal Revenue Code (IRC) as **regulated investment companies (RICs)**, and may be registered as investment companies under the 1940 Act and the Securities Act of 1933 (the 1933 Act) (and the Securities Exchange Act of 1934 [the 1934 Act] as appropriate). A feeder fund also may be organized with a multiple-class structure. A feeder fund may also be organized under a different legal structure if it is not a registered product and is being used as a vehicle for nonpublic investing. If the master fund is organized outside the United States, it may serve as an investment vehicle for both offshore feeder funds sold solely to foreign investors and to domestic feeder funds sold solely to U.S. investors.

Operational and Accounting Issues

Multiple-Class Funds

5.07 Multiple-class funds have unique operational and accounting issues. These issues include the methods and procedures (a) to allocate income, expenses, and gains or losses to the various classes to determine the net asset value per share for each class; (b) to calculate dividends and distributions to shareholders for each class; and (c) to calculate investment performance for each class (such as total **return** and Securities and Exchange Commission [SEC] **yield**).

5.08 Rule 18f-3 under the 1940 Act establishes a framework for an open-end fund's issuance of multiple classes of shares representing interests in the same portfolio. Before the adoption of the rule, funds were required to obtain an exemptive order from the SEC to initiate a multiple-class structure. The rule permits certain differences in expenses between classes and prescribes how income, expenses, and realized and unrealized gains and losses may be allocated among the classes. Funds operating under existing multiple-class exemptive orders may elect either to adopt the rule or to continue to follow all of the terms and conditions set forth in their exemptive order.

5.09 To calculate the net asset value per share of each class for multiple-class funds, income, expenses, and realized and unrealized gains or losses must be allocated to each class. Fees and expenses of the fund need to be classified as either fund or class-level expenses. Fund-level expenses, such as investment management fees, apply to all classes. Rule 18f-3 identifies certain expenses, such as distribution and servicing fees, as being class-level expenses and requires that they be generally charged directly to the individual classes to which they relate. Under the rule, other expenses, such as transfer-agent and registration fees attributable to individual classes, may be designated as class-level expenses at the discretion of the fund's board of directors or remain fund-level expenses. All other expenses are allocated among the classes based on a methodology discussed in paragraph 5.12. Rule 18f-3 provides for the exercise of judgment by the fund and its directors as to the appropriateness and fairness of the expense allocation methodology. Because certain expenses are charged to the classes of shares differently, net asset value per share and dividends per share must be calculated separately for each class of shares. Class B shareholders will normally receive a smaller dividend per share from net investment income than Class A shareholders because of higher distribution and servicing fees. Net asset value per share may differ among classes.

5.10 Each class of shares bears all its identified class-specific expenses. The Internal Revenue Service (IRS) currently takes the position that funds with multiple classes have only one class of shares for tax purposes. Revenue Procedure 96-47 essentially provides that if a fund pays dividends of differing amounts (differential dividends) to its various classes of shares pursuant to a capital structure allowed by (or similar to that allowed by) rule 18f-3, the IRS will not consider such dividends to be preferential. This Revenue Procedure allows differential dividends due to divergent charges for items such as 12b-1 fees, shareholder servicing fees, and any other class-specific expenses. Fund-level expenses, such as management fees, custodian fees, and other expenses related to the management of the company's assets, must be allocated proportionally among all classes using an allocation methodology discussed in 5.12.

5.11 Class-specific expenses may be waived or reimbursed at different amounts for individual classes. However, rule 18f-3 requires a fund's board of directors to monitor waivers or reimbursements to guard against cross-subsidization among the classes. Fund management must also ensure that such waivers or reimbursements do not create a preferential dividend to a particular class of shares from a tax perspective. Revenue Procedure 99-40 covers circumstances under which such expenses may be reimbursed for tax purposes. To protect itself from an inadvertent preferential dividend, a rigorous approach to the documentation of class expense differences (including waivers or reimbursements), and also compliance with any private letter rulings, should be followed carefully by multiple-class funds. See paragraphs 6.61 and 6.62 for more specific guidance regarding preferential dividends.

5.12 The methods for allocating income, fund-level expenses, and realized and unrealized gains or losses set forth in rule 18f-3 are as follows:

- *Fair value of shares outstanding—relative net assets.* Under this method, each class of shares participates based on the total net asset value of its shares in proportion to the total net assets of the fund. Under rule 18f-3, it is expected that this method will be the primary method used to allocate income, fund-level expenses, and realized and unrealized gains and losses for calculating the net asset value of nondaily dividend funds.
- *Fair value of settled shares outstanding.* Under this method, earnings are allocated based on the fair value of settled shares. It is typically

used to achieve consistency between the allocation method and a fund's dividend policy with respect to the shares eligible to receive dividends. For example, most daily dividend funds pay dividends only to settled shares and, therefore, in a fund that requires settlement of its shares on a trade-date-plus-three basis, the appropriate basis of allocation of income and nonclass-specific expenses would be the fair value of settled shares. Rule 18f-3 permits daily dividend funds to use the settled-shares method for allocating income and expenses and the relative-net-assets method for allocating realized and unrealized gains and losses.

- *Shares outstanding*. This method provides for each share outstanding to participate equally in the nonclass-specific items of income, expense, gains, and losses. Under rule 18f-3, this method may be used by funds provided (a) that the fund is a daily dividend fund that maintains the same net asset value per share in each class, (b) that the fund has agreements in place for waivers or reimbursements of expenses to ensure that all classes maintain the same per share net asset value, and (c) that payments waived or reimbursed under such agreements may not be carried forward or recouped at a future date.
- *Simultaneous equations*. This method ensures that the annualized rate of return of each class will differ from that of the other classes only by the expense differential among the classes.
- *Any appropriate method*. A fund may use any appropriate allocation method so long as a majority of the fund's directors, including a majority of the directors who are not interested persons of the fund, determines that the method is fair to the shareholders of each class and that the annualized rate of return of each class will generally differ from that of the other classes only by the expense differentials among the classes.

Whichever method is selected, rule 18f-3 requires the fund to use that method consistently. Illustrations using the allocation methods discussed above are presented in exhibit 5.1.

5.13 Rule 18f-3 does not specify any requirements regarding the distribution calculation methods that a multiple-class fund should use. The methods generally used to calculate distributions to shareholders from net investment income are as follows:

- *Record share method*. The sum of net investment income available for all classes after deducting allocated expenses, but before consideration of class-specific expenses, is divided by the total outstanding shares on the dividend record date for all classes to arrive at a gross dividend rate for all shares. From this gross rate, an amount per share for each class (the amount of incremental expenses accrued during the period divided by the record date shares outstanding for the class) is subtracted. The result is the per share dividend available for each class.
- *Actual income available method*. Actual net investment income that has been allocated to each class (as recorded on the books) is divided by the record date shares for each class to derive the dividend payable per share.
- *Simultaneous equations method*. This method seeks to ensure, by using simultaneous equations, that the distribution rates will differ among the classes by the anticipated differential in expense ratios.

5.14 The record share method is most commonly used by funds that do not pay dividends daily (nondaily dividend funds). It is also used by daily dividend funds that employ policies to manage their dividend payout levels (such as to distribute stable dividend amounts or to compensate for book-tax differences). The dividend payout level may be managed for only one share class; the dividend rates for the other classes will vary because class-level expenses differ between classes. The record share method is simple to apply, provides assurance that the annualized distribution rate for the class with higher expenses will be lower than that for the class with lower expenses, and minimizes the likelihood of a preferential dividend being paid. The disadvantage of this method is that the annualized distribution rates of the various classes usually will not reflect the precise expense ratio difference between the classes, because the directly related expenses accrued over time on a varying number of shares are reduced to a per share amount on the record date shares. The larger the fluctuation in shares over time, the greater the potential difference.

5.15 The actual income available method is used for funds that declare daily dividends per share equal to the amount of net investment income allocated to each class. This results in the same per share net asset value for all classes (except for differences that may result from rounding). The actual income available method is not typically used for funds that pay dividends on a periodic basis.

5.16 The simultaneous equations method is used for periodic dividend funds and is more complex than other methods. This method ensures that the annualized distribution rates will differ among classes by the approximate amount of the expense ratio difference. Per share NAV will usually converge after the dividend has been recorded.

5.17 Because distribution amounts under both the record-share and the simultaneous equations methods are determined independently of the amount of net investment income allocated to each class, situations can result whereby, after recording the dividends, one class has positive undistributed income while the other class is negative. For financial reporting purposes, a return of capital is not determined at the class level and distributable earnings is disclosed only at the fund level.

5.18 To avoid paying a preferential dividend for tax purposes, multiple-class funds should declare long-term capital gain distributions at the fund level rather than at the class level, so that all shares receive the same per share gain distribution. This is so regardless of the frequency of income dividends or the distribution calculation method selected. Illustrations of the above distribution calculation methods are presented in exhibit 5.2.

Master-Feeder Funds

5.19 Master-feeder sponsors sometimes apply to the IRS for a private letter ruling to ensure that the master will be treated as a partnership for federal income tax purposes and that each feeder will be treated as an owner of its proportionate share of the earnings and profits and net assets of the master. This is to make sure that the feeders maintain their status as regulated investment companies and can afford their shareholders the pass-through tax benefits that result from that status.

5.20 Master-feeder accounting involves allocating the master portfolio's income, expenses, and realized and unrealized gains and losses among its feeder funds. Because most master funds are typically structured as partnerships for tax purposes, the allocation of income, expenses, gains, and losses follows partnership tax allocation rules (partner's distributive share rules as provided for in section 704(b) of the IRC). Each feeder must be allocated its share of gain or loss realized by the master when the master disposes of a particular security lot. The tax allocation process is complicated because the relative interest of the feeder funds in the master portfolio changes, usually daily, as feeder fund shares are sold or redeemed. Before final regulations that apply after December 21, 1993, the IRC required this allocation to follow the literal partnership allocation methodology that implies a "property-by-property" method for investment partnerships. Performing tax allocations under the property-by-property method requires evaluating each feeder's share of the realized gain or loss on the security lot sold. The final regulations allow allocation based on an aggregate method. In the absence of a ruling from the IRS, the regulation allowing an "aggregate method" for allocating gains and losses does not apply to built-in gains and losses from securities contributed by a feeder to a master in a nontaxable event. However, certain "qualified" master feeders that meet the requirements of Revenue Procedure 2001-36, are permitted to use the aggregate method for contributed property; although other fund groups would still require a private letter ruling from the IRS. Performing tax allocation under the aggregate method requires evaluating each feeder's share of the unrealized gains or losses on its entire (that is, aggregate) interest in the master, rather than each feeder's share of the realized gain or loss on the sold security lot alone.

Funds of Funds

5.21 Funds of funds are investment companies that invest in other investment companies. Funds of funds have been popular in the investment partnership market and have recently become more popular in the registered fund market. Master-feeder structures can be viewed as funds of funds, but usually only with one top-tier (portfolio) fund; a more typical fund of funds structure has more than one top-tier fund. Historically, a registered investment company's ability to invest in other investment companies was limited by section 12(d) of the Investment Company Act of 1940. Under section 12(d), an open-end investment company is limited, among other restrictions, to aggregate investments in other investment companies of 10 percent of the acquiring company's total assets. Master-feeder structures, however, are specifically permitted by section 12(d)-(I)(E)(ii) of the Act. As a result, except for a limited number of registered funds that received exemptive orders from the SEC, fund of funds structures have been limited to unregistered investment companies. In 1996, section 12(d) was amended to permit registered investment companies to invest in other investment companies provided that both the investor and investee funds were part of the same group of investment companies (affiliated funds). Investments in nonaffiliated funds would continue to be subject to the historical limitations under section 12(d) unless an exemptive order is obtained from the SEC.

5.22 Many multitiered structures are U.S. domiciled, but recent trends include the creation of offshore, domestic, and blended structures. A blended structure might include a fund with significant investments in other investment companies and also investments in individual securities. Participants in such structures include both foreign and domestic investors, individually and through funds, commodity pools, retirement accounts, and other sources.

5.23 For publicly-traded investee funds, market quotes are usually available. For those investee funds that are not publicly traded, market quotes may not be readily available. In such instances, the fair value of investments in investee funds, as determined by the investor fund's board of directors or management, should be used to value the investments on the books of the investor fund. Fair value may be determined by reference to the investor fund's interest in the investee fund's net assets. The valuation of an investee fund by the investor should reflect any incentive or performance fee or **incentive allocation** of earnings to the general partner based on the current performance of the investee fund.

Other Considerations for Investments in Nonpublicly Traded Investees

5.24 Proper execution of the fund of funds strategy requires management of the investor fund to exercise significant judgment in selecting and monitoring the performance of the investee funds. Occasionally, management may engage an outside consultant to assist in the performance monitoring and selection process. Because this process may include many procedures, a review of prior audited financial results should be included.

5.25 Monitoring the performance is an essential control in the operation of the fund. Fund management should review regular (for example quarterly) investment results and periodically review the trading strategy being followed by the investee company to make sure that it is consistent with the strategy approved at the time of the initial investment. The results of daily monitoring functions established by management of the investee company should also be reviewed periodically. Discussions with each investee company to identify any significant changes or problems with systems, illiquid securities, personnel, or trading strategies should be held periodically and documented. At times, such as when there are significant changes in market conditions or a particularly risky strategy, monthly or more frequent discussions may be advisable. Another essential control that management of the investor fund should exercise is comparison of preliminary annual results reported by the investee fund to the investee fund's audited financial statements. The audited financial statements should substantiate the reliability of the investee fund's reporting processes.

5.26 As an additional control over the valuation process, management of the investor fund may wait for receipt of audited financial statements and individual capital account statements from investee funds to make sure no significant changes in previously reported results have occurred before the investor fund issues its audited financial statements. This approach provides key audit evidence and instills discipline into the investor fund's financial reporting system.

Financial Statement Presentation

5.27 In addition to the financial statement reporting requirements in chapter 7, management investment companies that have multiple classes of shares or master-feeder structures follow reporting guidelines discussed below when preparing financial statements, including financial highlights. Illustrations are presented at the end of this chapter.

Multiple-Class Funds

5.28 Refer to exhibit 5.3 for examples of each of the following three statements. *Statement of Assets and Liabilities.* The composition of net assets is reported in total, but net asset value per share and shares outstanding should be reported for each class. The maximum public offering price per share is often reported for each class.

5.29 *Statement of Operations.* Class-specific expenses are reported for each class (or disclosed in the notes to the financial statements). Reporting the amount of fund-level expenses allocated to each class is not required. However, some funds voluntarily disclose fund-level expenses by class in the statement of operations or in notes to the financial statements.

5.30 *Statement of Changes in Net Assets.* Dividends and distributions paid to shareholders and capital share transactions for each class are required to be presented (or disclosed in the notes to the financial statements).

5.31 *Notes to Financial Statements.* The notes should—

- Describe each class of shares, including sales charges, shareholder servicing fees, and distribution fees.
- Disclose the method used to allocate income and expenses, and realized and unrealized capital gains and losses, to each class.
- Describe fee arrangements for class-specific distribution plans and for any other class-level expenses paid to affiliates.
- Disclose capital share transactions (if not disclosed separately in the statement of changes in net assets) for each class.
- Disclose total sales charges paid to any affiliates for each class.

5.32 *Financial Highlights.* Financial highlights, including total return, should be presented by class except for portfolio turnover,[1] which is calculated at the fund level. Because the financial highlights table is considered to be a financial statement disclosure and not a financial statement, the SEC has accepted the presentation of a financial highlights table only for a specific class or classes of shareholders for whom the financial statements are intended. The financial highlights for any class for which the shareholders are precluded from investing in may be omitted. In such situations, the auditor's report should be addressed to the fund board and the shareholders in the specific class or classes and not to all shareholders taken as a whole.

Master-Feeder Funds

5.33 Under current SEC policies, the annual and semiannual reports for feeder funds should contain two sets of financial statements, one for the master fund and the other for the specific feeder fund. (Refer to exhibits 5.4 and 5.5 for illustrative financial statements. Items below correspond to these exhibits.) When the master and feeder funds have different year ends, the SEC has indicated[2] that it would not object if, at each feeder investment company year end, the audited shareholder report of the feeder is accompanied by the latest audited shareholder report of the master as well as an unaudited balance sheet and schedule of investments of the master as of the date of the feeder's financial statements.

5.34 *Statement of Assets and Liabilities.* Each *feeder fund's* statement of assets and liabilities shows an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder funds' investments in the master fund should equal the total net assets of the master fund.

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[1] Portfolio turnover is required for registered investment companies only. See paragraph 7.69.

[2] See the December 30, 1998, "Dear CFO Letter" issued by the Chief Accountant of the Securities and Exchange Commission Division of Investment Management.

A schedule of portfolio investments is not presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets should be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this chapter.

5.35 *Master funds* are usually organized as trusts with flow-through accounting treatment to their feeder funds. As such, the statement of assets and liabilities of the master fund usually does not report the components of net assets, shares outstanding, or net asset value per share.

5.36 The *portfolio of investments* is included only in the master fund's financial statements.

5.37 *Statement of Operations.* The statement of operations reports details of the *feeder fund's* allocated share of net investment income from the master fund (that is, separate disclosure of allocated interest, dividends, and expenses). The statement also reports separately the feeder's allocated share of the master fund's realized and unrealized gains and losses. The total of all feeders' income, expense, and realized and unrealized gain or loss components should agree to the corresponding totals of the master fund. Feeder funds should disclose their fund-specific expenses, such as transfer agent, distribution, legal and audit expenses, and registration and directors' fees. Additionally, any fee waivers or reimbursements at the feeder-fund level should be reported.

5.38 For *master funds*, the standard reporting format for investment companies with simple capital structures is used.

5.39 *Statement of Changes in Net Assets.* For *feeder funds*, the standard reporting format for investment companies with simple capital structures is used. If the feeder fund is a multiple-class fund, the guidance of paragraphs 5.27 to 5.32 should be followed.

5.40 The statement of changes in net assets of a *master fund* should report capital transactions from or to feeder funds as contributions and withdrawals, respectively. Dividend distributions are normally not made by the master fund when the master fund is treated as a partnership for tax purposes. In those situations where the master fund is treated as a RIC and is taxed either as a corporation or trust, there may be distributions to the feeder funds to eliminate any accumulated taxable income at the master fund level.

5.41 *Notes to Financial Statements.* Notes to the financial statements of each *feeder fund* should include—

- A general description of the master and feeder structure.
- The feeder's percentage ownership share of the particular master fund at the reporting date.
- A statement that the feeder invests all of its investable assets in a corresponding open-end management investment company having the same investment objectives as the feeder, and a reference to the financial statements of the master fund, including the portfolio of investments.

5.42 The notes should disclose or refer to the accounting policies of the master fund that affect the feeders (such as valuation of investments of the master fund). Information concerning the purchases and sales of investments and gross unrealized appreciation or depreciation of investments on a tax basis (required by Regulation S-X) is not applicable to the feeder's financial statements.

5.43 *Financial Highlights.* The feeder fund's ratios of expenses and net investment income to average net assets should include the expenses of both the feeder and the master fund. Balance credits earned by the master fund should be reflected in the feeder fund ratios as if they had been earned by the feeder fund directly. *Feeder funds* need not disclose a **portfolio turnover rate** because feeders invest all their assets in the master fund. However, to the extent the financial highlights table conforms to the instructions of Form N-1A, it should report the portfolio turnover rate experienced by the master. The financial highlights of feeder funds that are registered investment companies should comply with the same requirements as for registered investment companies not organized in a master-feeder structure (see paragraphs 7.65 through 7.70).

5.44 The financial highlights section of the *master fund* organized as a partnership is substantially modified, because per share information is not applicable. The master fund financial highlights section should include the total return, ratios of expenses and net investment income to average net assets, and portfolio turnover rate.[3] The financial highlights section of master funds not organized as a partnership should report the normal per share data.

5.45 *Auditor's Report.* The auditor's report for the feeder fund is modified to exclude the phrase "including the portfolio of investments" because the portfolio of investments is not part of the feeder fund's financial statements.

Funds of Funds[*]

5.46 *Example Financial Statements.* Exhibit 5.6 contains illustrations of relevant fund of funds financial statements. Items discussed below refer to this exhibit.

5.47 *Statement of Assets and Liabilities.* The reporting fund may list the investee (portfolio) funds directly on the statement of assets and liabilities. Additional disclosures may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. However, there is usually no need for a separate schedule of investments.

5.48 Fund management should consider whether an investment in a single underlying fund is so significant to the fund of funds as to make the presentation of financial statements in a manner similar to a master-feeder fund (paragraphs 5.94 to 5.102) more appropriate.

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[3] Portfolio turnover is required for registered investment companies only. See paragraph 7.69.

[*] In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships,* that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

A final pronouncement is expected to be issued in the fourth quarter of 2003. A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

5.49 *Statement of Operations.* Income reflected on the statement of operations should represent the net earnings received from investee funds. For example, if the investee funds are all registered investment companies (as in the example in the exhibit), then the income would represent the dividends received from such investee funds. The investor fund may not reflect any operating expenses if the investee funds have agreed to assume certain of the investor fund expenses. To the extent the investor fund has such agreements, they should be disclosed in the notes.

5.50 When investing in registered investment companies, distributions received from long-term capital gains should be reported as realized gains together with gains realized on disposition of shares of investee companies.

5.51 Expenses are those incurred only at the reporting fund level. Expenses of the investee funds are embedded in the net earnings from such funds.

5.52 *Financial Highlights.* The financial highlights for the reporting fund in a fund-of-funds structure are usually similar to a standalone feeder fund in a master-feeder structure. Net investment income and expense ratios should be computed based upon the amounts reported in the statement of operations, and portfolio turnover should be measured based on the turnover of investments made by the reporting fund in the investee funds, not looking through the investee funds to their portfolio activity.

5.53 *Notes to Financial Statements.* Fund management should consider whether, and to what extent, disclosure of the investee funds' investment policies is appropriate. Notes to the financial statements of the reporting fund should include—

- A general description of the fund of funds structure.
- Disclosure of valuation policy-values, generally based on information reported by investee funds.

Audit Considerations

5.54 Many master-feeder structures are capitalized by transferring the investments and related assets and liabilities of an existing fund to a newly organized master fund. In exchange for the assets transferred, the original fund becomes a feeder fund and receives a proportional ownership interest in the master fund. The auditor should be aware that management may obtain a private letter ruling from the IRS, or tax opinions from counsel in certain instances, to ensure treatment as a tax-free contribution. The auditor should also be familiar with the tax rules that may require subsequent tracking and special allocation of the contributed unrealized gain or loss on the investments transferred to the master fund.

5.55 For multiple-class funds electing to continue to operate under the terms of their exemptive orders, the SEC requires an expert's opinion from the fund's auditors regarding the adequacy of the systems and internal controls to achieve the stated objectives included in the exemptive order request. The expert's opinion is required to be included each year in the fund's year-end Form N-SAR filing. The annual expert's opinion is not required for funds operating under rule 18f-3, which permits adoption of a multiple-class structure without an exemptive order, subject to certain parameters.

5.56 *Multiple-Class Funds.* In connection with the audit of multiple-class funds, auditors should consider whether—

- Class-level and fund-level expenses have been determined as required by rule 18f-3 or as specified in the fund's SEC exemptive order.

- Income, expenses, and realized and unrealized gains or losses have been allocated among the classes of shares in accordance with the allocation methods in rule 18f-3 or in the fund's SEC exemptive order.
- IRS regulations have been considered regarding the maintenance of class-level expense differentials necessary to avoid preferential dividends for income tax purposes.
- Differences between expense and net investment income ratios of various share classes appear reasonable when compared with the amount or percentage differences in class-level expenses.

5.57 *Master-Feeder Funds.* In connection with the audit of master-feeder funds, auditors should consider whether—

- Fees and expenses incurred by the master fund or feeder funds are in accordance with contractual agreements as disclosed in the registration statement. Advisory and custodian fees are normally incurred only at the master fund; fees and expenses relating to distribution and shareholder servicing are normally incurred at the feeder level.
- Controls and procedures are adequate to ensure that investment valuation and related income components are allocated properly to feeder funds.
- Systems and controls are adequate to record accurately and timely the daily contributions and withdrawals between the feeder funds and the master fund. This is important to determine properly each feeder fund's proportionate ownership interest for purposes of computing daily allocations. All shareholder purchases and redemptions are recorded at the feeder level. Assuming that cash is transferred on the same day, after the total daily net sales or redemptions are known for each feeder, contributions and withdrawals in the master fund are recorded to reflect changes in the feeders' ownership interests (that is, a net redemption at the feeder level will result in a withdrawal from the master fund). All such transactions at the feeder level affect the investment in the master fund. At the master fund level, the cash movements flow through the partnership equity or net assets account.
- Satisfaction has been obtained as to the accuracy of master fund tax adjustments allocated to the feeder funds.

5.58 A master-feeder structure could consist of a master fund and feeder funds that are not related to each other, except that they are each feeders of the same master fund. Each feeder could have a different auditor who may also differ from the auditor of the master fund. It is also possible that the master and feeder funds could have different year ends. In connection with the audit of feeder funds having different auditors or year ends from those of the master fund, the following audit considerations should be taken into account.

Planning

5.59 The feeder fund auditor should discuss with the master fund's independent auditor the results of the most recent audit of the master fund.

5.60 The feeder fund auditor should inquire of feeder fund and master fund management as to any changes in fee structures, affiliated transactions, significant contingencies, results of regulatory reviews, or proposed transactions since the previous feeder fund and master fund audits. Consideration should be given to the implications of such changes on the nature, scope, and timing of audit testing and feeder fund financial statement presentation and disclosure.

5.61 Timing and logistics considerations will make planning and coordination among the management and auditors of the master and feeder funds necessary.

Control Environment

5.62 Feeder fund auditors should evaluate the control environment at the master fund. Consideration should be given to the matters referred to in paragraph 5.48. Consideration should also be given to the scope and results of relevant SAS 70 reports, if available. The timing, scope, and results of tests of controls performed by the master fund's auditors should be considered.

5.63 The feeder fund auditor should consider whether to review the master fund auditor's workpapers related to the evaluation and testing of the master fund's control environment.

5.64 The feeder fund auditor should consider the control and monitoring procedures performed by the feeder fund's management over its investment in the master fund. Tests of these control procedures should be considered.

5.65 Inquiries should be made of the master fund's management and auditors with respect to changes or issues in the control environment since the last fiscal year end of the master fund or since the performance of the most recent tests of controls.

5.66 Based upon the results of the feeder fund auditor's evaluation of the control environment at the master fund, the feeder fund auditor should consider requesting the master fund auditor to perform, or directly perform, additional tests of controls.

Investment in Master Fund and Income-Gain Allocations

5.67 The auditor should obtain, as of the date of the feeder fund's financial statements, an understanding of the nature of securities held by the master fund and the procedures used to value these securities. Consideration should be given to requesting the master fund auditor to perform, or directly perform, additional procedures, particularly related to fair valued,[4] illiquid, or difficult-to-price securities. This may be particularly relevant if the feeder fund has a different year end from the master fund.

5.68 The auditor should consider requesting the master fund auditor to review the master fund's reconciliation of portfolio securities with the custodian bank and brokers as of the date of the feeder fund's financial statements. Based upon the results of these procedures, the auditor should consider whether to request the master fund auditor to confirm, or directly confirm, the existence of the master fund's investments in securities with the custodian and brokers as of the date of the feeder fund's financial statements.

5.69 The feeder fund auditor should consider whether to review the master fund auditor's workpapers related to valuation testing, existence testing, or both types of testing, as of the most recent master fund audit.

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[4] In January 2003, the ASB issued Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

In the future, the ASB plans to issue an audit guide that will include guidance on auditing fair value measurements and disclosures relating to specific assets, liabilities, components of equity, or transactions.

5.70 The auditor should consider obtaining confirmation from master fund management, as of the date of the feeder fund financial statements, of: (a) the value of the feeder fund's investment in the master fund; (b) the feeder fund's percentage ownership in the master fund; and (c) allocations of income or gain from the master fund to the feeder fund during the period under audit.

Other Transactions

5.71 Through discussions with feeder fund and master fund management and review of accounting records, the auditor should consider whether significant transactions of the master fund have been accounted for properly and disclosed properly in the feeder fund's financial statements.

Prospectus Restrictions and Compliance

5.72 The auditor should consider making inquiries of master fund management with respect to the results of investment restrictions compliance monitoring, including any detected compliance violations and related resolutions during the period of the feeder fund financial statements.

5.73 The auditor should consider requesting the master fund auditor to review, or directly reviewing, the analyses and documentation with respect to the master fund's investment restrictions compliance.

5.74 The feeder fund auditor should consider whether to review related master fund auditor's workpapers. The feeder fund auditor should also consider requesting the master fund auditor to perform, or directly performing, additional tests based upon the results and timing of such inquiries.

5.75 Consideration should be given to obtaining representations related to investment compliance from master fund management.

Tax Qualifications and Compliance

5.76 The auditor should consider reviewing analyses and documentation with respect to the master fund's tax compliance. Any tests of compliance with diversification requirements need to be met for both the master's as well as the feeder's fiscal periods.

5.77 The auditor should test feeder fund tax compliance (for example, sufficiency of distributions) for the period of the financial statements.

5.78 The feeder fund auditor should consider whether to review related master fund auditor's workpapers.

5.79 The auditor should consider obtaining tax-related representations from master fund management.

Financial Statements

5.80 The auditor should consider obtaining representations from feeder fund management that the financial statements reflect the value of the feeder fund's investment in the master fund.

5.81 The feeder fund auditor should read the most recent financial statements of the master fund.

5.82 Generally, when master and feeder funds share common reporting periods, the feeder fund's auditor's report should not be dated prior to the master fund's auditor's report.

Funds of Funds

5.83 Significant audit risk may exist if management does not use strong procedural controls in selecting and monitoring a fund's investments in investee companies and determining the investments' fair value. The audit approach to an investor fund's investments in investee funds should focus on two areas:

a. Evaluating the investor and investee funds' control environments

b. Substantiating the fair value attributed to investments in investee funds[5]

Control Environment

5.84 The primary concern in the control environment relates to the procedures that management of the investor fund uses to monitor its investments in investee funds. Investments in public investee funds may be valued based on reported daily net asset values, and the auditor may rely upon the structure established by the 1940 and 1933 Acts to gain comfort that such reported fair values are accurate.

5.85 For investments in nonpublic investee companies, audit tests may include participation in management site visits or telephone calls to investee funds, or a review of documentation of such visits or calls. Prior experience with the investee funds' management, results of prior-year audits, or the history of adjustments to unaudited results reported by the investee funds, if any, should be considered in determining the extent to which such participation is necessary. For example, participation in management site visits would be more appropriate if the investee funds represented a significant investment by the investor fund or if serious concerns as to the management controls at the investee fund existed. The auditor should also review the investor fund's reconciliation of the unaudited financial results received from the investee funds to their audited financial statements for the prior year, if the current year's audited financial statements are not available. Any significant variations, their causes, and their effect on the investor fund's financial statements should be identified.

5.86 If significant variations are discovered in the comparison of prior-year audited financial statements with financial information obtained from the investee funds, the auditor should consider participating in the management site visit, reviewing the investee fund's audited financial statements, or vouching withdrawals, if any, made from the investee fund after year end as part of the annual audit tests.

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[5] In January 2003, the ASB issued Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

In the future, the ASB plans to issue an audit guide that will include guidance on auditing fair value measurements and disclosures relating to specific assets, liabilities, components of equity, or transactions.

Exhibit 5.1

5.87

Methods of Allocating Income, Fund-Level Expenses, and Realized and Unrealized Gains (Losses)

	Total	*Class A*	*Class B*
Assumptions:			
Total shares outstanding		2,000,000	3,000,000
Settled shares outstanding		1,990,000	2,900,000
Net asset value per share		$ 10.52	$ 10.49
Fair Value of Shares Outstanding—Relative Net Assets:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Net asset value per share		$ 10.52	$ 10.49
Net asset value	$52,510,000	$21,040,000	$31,470,000
Allocation percentage		40.0686%	59.9314%
Fair Value of Settled Shares Outstanding:			
Settled shares outstanding	4,890,000	1,990,000	2,900,000
Net asset value per share		$ 10.52	$ 10.49
	$51,355,800	$20,934,800	$30,421,000
Allocation percentage		40.7642%	59.2358%
Shares Outstanding:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Allocation percentage		40.0%	60.0%

Exhibit 5.2

5.88

Methods of Computing Income Distributions Per Share

	Total	*Class A*	*Class B*
Assumptions:			
Net investment income before class-specific expenses	$1,000,000		
Class-specific expenses:			
Class A		$ 13,000	
Class B			$ 59,000
Record date shares outstanding	5,000,000	2,000,000	3,000,000
Record Share Method			
Net investment income before class-specific expenses	$1,000,000		
Total record date shares outstanding	5,000,000		
Gross dividend rate for all shares	$ .2000	$ .2000	$ .2000
Per share class-specific expenses:			
Class A ($13,000/2,000,000)		(.0065)	
Class B ($59,000/3,000,000)			(.0197)
Per share dividend for each class		$ .1935	$ .1803
Actual Income Available Method			
Actual net investment income recorded on books of each class	$ 928,000	$ 417,600	$ 510,400
Record date shares outstanding for each class		2,000,000	3,000,000
Per share dividend for each class		$ .2088	$ .1701

(continued)

Exhibit 5.2 (continued)

Methods of Computing Income Distributions Per Share

Simultaneous Equations Method

EQUATION #1: A + B = $928,000

Where—A and B represent the total dividend amounts to be paid to each class.

EQUATION #2: A/2,000,000 – B/3,000,000 = (0.5% × $10.50)/4

Where
2,000,000 and 3,000,000 represent the record date shares of each class
0.5% represents the expense differential between Class A and Class B
$10.50 represents the average daily net asset value of the fund
4 refers to the fact that the dividend period is a quarter

Solving the above simultaneous equations produces the following results:

	Total	*Class A*	*Class B*
Total dividends to be paid	$928,000	$ 386,961	$ 541,039
Record date shares outstanding for each class		2,000,000	3,000,000
Per share dividend for each class		$ .1935	$ .1803
Annualized distribution rates to average daily net asset value		7.37%	6.87%
Difference in distribution rates		0.50%	

Exhibit 5.3

5.89

XYZ Multiple-Class Fund
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investments in securities, at fair value, identified cost $18,674,000	$21,101,000
Cash	199,000
Deposits with brokers for securities sold short	1,555,000
Collateral for securities loaned, at fair value	620,000
Receivables:	
Dividends and interest	46,000
Investment securities sold	24,000
Capital stock sold	54,000
Other assets	26,000
Total assets	23,625,000
Liabilities	
Options written, at fair value (premiums received $110,000)	230,000
Securities sold short, at fair value (proceeds $1,555,000)	1,673,000
Demand loan payable to bank	2,000,000
Payable upon return of securities loaned	620,000
Due to broker—variation margin	10,000
Payables:	
Investment securities purchased	52,000
Capital stock reacquired	8,000
Other	4,000
Accrued expenses	8,000
Distribution payable	158,000
Total liabilities	4,763,000
Net assets	$18,862,000
Net assets consist of:	
Paid-in capital	$15,184,000
Distributable earnings	3,678,000
Total net assets	$18,862,000
Net asset value per share:	
Class A—based on net assets of $15,089,600 and 3,375,750 shares outstanding	$ 4.47
Class A public offering price ($4.47 net asset value divided by .95)	$ 4.71
Class B—based on net assets of $3,772,400 and 845,830 shares outstanding	$ 4.46

The accompanying notes are an integral part of these financial statements.

Exhibit 5.3 (continued)

5.90

XYZ Multiple-Class Fund
Statement of Operations
Year Ended December 31, 20X4

Investment income:	
Dividends (net of foreign withholding taxes of $20,000)	$ 742,000
Interest	209,000
Income from loaned securities—net	50,000
Total income	1,001,000
Expenses:	
Investment advisory fee	137,400
Service fees—Class A	36,600
Distribution and service fees—Class B	37,000
Interest	10,000
Professional fees	18,000
Custodian	5,000
Transfer agent fees—Class A	10,000
Transfer agent fees—Class B	12,000
Directors' fees	10,000
Dividends on securities sold short	3,000
Total gross expenses	279,000
Less waivers:	
Distribution and service fees—Class B	(18,500)
Advisory fee	(34,500)
Total net expenses	226,000
Investment income—net	775,000
Realized and unrealized gain (loss) on investments:	
Net realized gain (loss) on investments	1,089,000
Net change in unrealized appreciation (depreciation) on investments	(1,649,000)
Net loss on investments	(560,000)
Net increase in net assets resulting from operations	$ 215,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.3 (continued)

5.91

XYZ Multiple-Class Fund
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 775,000	$ 724,000
Net realized gain on investments	1,089,000	1,000,000
Change in unrealized appreciation or depreciation	(1,649,000)	1,319,000
Net increase in net assets resulting from operations	215,000	3,043,000
Distributions to shareholders:		
Class A	(1,505,250)	(1,104,500)
Class B	(360,750)	(239,500)
Tax return of capital:		
Class A	—	(52,800)
Class B	—	(13,200)
Total distributions	(1,866,000)	(1,410,000)
Net increase from capital share transactions	2,721,000	4,700,000
Total increase in net assets	1,070,000	6,333,000
Net assets:		
Beginning of year	17,792,000	11,459,000
End of year	$18,862,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.3 (continued)

5.92

XYZ Multiple-Class Fund
Notes to Financial Statements

[The following notes are limited to illustrations of disclosures unique to a multiple-class fund structure. In addition to the disclosures provided, notes for a multiple-class fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7.]

1. Significant Accounting Policies

XYZ Multiple-Class Fund (the Fund) is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The Fund offers two classes of shares (Class A and Class B). Each class of shares has equal rights as to earnings and assets except that each class bears different distribution, shareholder service, and transfer agent expenses. Each class of shares has exclusive voting rights with respect to matters that affect just that class. Income, expenses (other than expenses attributable to a specific class), and realized and unrealized gains or losses on investments are allocated to each class of shares based on its relative net assets. Class B shares automatically convert to Class A shares at the end of the month following the eighth anniversary of issuance.

2. Capital Share Transactions

The Fund is authorized to issue an unlimited number of shares in an unlimited number of classes.

Transactions in the capital shares of the Fund were as follows:

	20X4		*20X3*	
	Shares	*Amount*	*Shares*	*Amount*
Class A:				
Shares sold	309,000	$1,444,500	690,500	$3,176,000
Shares issued from reinvestments	195,000	1,040,000	171,000	770,000
Shares redeemed	(57,000)	(253,500)	(40,000)	(186,000)
Net increase from capital share transactions	447,000	$2,231,000	821,500	$3,760,000
Class B:				
Shares sold	61,925	$ 290,100	185,000	$ 848,000
Shares issued from reinvestments	57,875	270,000	35,000	160,000
Shares redeemed	(15,000)	(70,100)	(15,000)	(68,000)
Net increase from capital share transactions	104,800	$ 490,000	205,000	$ 940,000

3. Investment Advisory Fees and Other Transactions With Affiliates

The Fund has entered into a distribution plan, pursuant to rule 12b-1 under the 1940 Act, with XYZ Distributors (Distributors). Under the plan, Class A shares pay a monthly shareholder servicing fee at an annual rate of 0.25 percent of Class A average daily net assets. Class B shares pay monthly shareholder servicing and distribution fees at the annual rate of 0.25 percent and 0.75 percent, respectively, of Class B average daily net assets. These fees compensate Distributors for the services it provides and for expenses borne by Distributors under the Agreement. During the year ended December 31, 20X4, Distributors waived $18,500 of its distribution fee related to Class B shares.

For the year ended December 31, 20X4, Distributors received $70,000 in sales commissions from the sale of Class A shares. Distributors also received $6,500 of contingent deferred sales charges relating to redemptions of Class B shares.

XYZ Service Company, an affiliate of Advisers, provides transfer agent services to the Fund. Under the transfer agent agreement with XYZ Service Company, the Fund pays a monthly fee equal, on an annual basis, to $15 and $18 per shareholder account for Class A and Class B shares, respectively.

Exhibit 5.3 (continued)

5.93

XYZ Multiple-Class Fund
Financial Highlights

	Class A			Class B		
	20X4	*20X3*	*20X2**	*20X4*	*20X3*	*20X2**
*Per share operating performance:***						
Net asset value, beginning of year	$ 4.88	$ 4.46	$ 4.00	$ 4.88	$ 4.45	$ 4.00
Income from investment operations:						
Net investment income	0.21	0.20	0.12	0.19	0.20	0.11
Net realized and unrealized gain (loss) on investment transactions	(0.12)	0.71	0.50	(0.12)	0.71	0.49
Total from investment operations	0.09	0.91	0.62	0.07	0.91	0.60
Less distributions:						
Dividends and distributions	(0.50)	(0.44)	(0.16)	(0.49)	(0.43)	(0.15)
Tax return of capital distributions	0	(0.05)	0	0	(0.05)	0
Total distributions	(0.50)	(0.49)	(0.16)	(0.49)	(0.48)	(0.15)
Net asset value, end of year	$ 4.47	$ 4.88	$ 4.46	$ 4.46	$ 4.88	$ 4.45
*Total return****	1.84%	20.40%	15.50%	1.43%	19.90%	15.00%
Percentages and supplemental data:						
Net assets, end of period (000s)	$15,090	$14,167	$9,167	$3,772	$3,625	$2,292
Ratios to average net assets:						
Expenses†	1.23%	1.30%	1.35%‡	1.48%	2.05%	2.10%‡
Net investment income†	4.15%	2.82%	4.00%‡	3.90%	2.07%	3.25%‡
Portfolio turnover rate	92%	80%	75%	92%	80%	75%

The accompanying notes are an integral part of these financial statements.

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* For the period from June 1, 20X2, commencement of operations, to December 31, 20X2.

** Selected data for a share of capital stock outstanding throughout the year.

*** Total return excludes the effect of sales charges.

† During 20X4, 20X3 and 20X2, the adviser and distributor voluntarily waived a portion of their advisory fee and a portion of the Class B distribution fee (0.50 percent). Absent these waivers, the expense percentages would have been approximately 1.48%, 1.55%, 1.60%, 2.23%, 2.80%, and 2.85%, respectively.

‡ Annualized.

Exhibit 5.4

5.94

ABC Feeder Fund, Inc.
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investment in ABC Master Portfolio	$15,089,600
Receivable for capital stock sold	110,000
Prepaid expenses and other assets	35,000
Total assets	15,234,600
Liabilities	
Administrative fee payable	20,000
Payable for capital stock redeemed	30,000
Dividends payable	40,000
Other accrued liabilities	25,000
Total liabilities	115,000
Net assets	$15,119,600
Net assets consist of:	
Paid-in capital, 1,250,000 shares outstanding	$12,258,600
Distributable earnings	2,861,000
Total net assets	$15,119,600
Net asset value per share	$ 12.10
Public offering price ($12.10 net asset value divided by 0.95)	$ 12.74

The accompanying notes are an integral part of these financial statements.

Exhibit 5.4 (continued)

5.95

ABC Feeder Fund, Inc.
Statement of Operations*
Year Ended December 31, 20X4

Net investment income allocated from ABC Master Portfolio:	
Dividends	$ 579,000
Interest	168,200
Income from loaned securities—net	40,000
Expenses**	(179,000)
Net investment income from ABC Master Portfolio	608,200
Fund expenses:	
Administrative fees	15,000
Distribution and servicing fees	37,500
Professional fees	12,000
Transfer agent fees	35,000
Directors' fees	10,000
Registration fees	26,000
Other expenses	12,000
Total expenses	147,500
Investment income—net	460,700
Realized and unrealized gain (loss) on investments allocated from ABC Master Portfolio:	
Net realized gain on investments	865,000
Net change in unrealized appreciation (depreciation) on investments	(1,320,000)
Net loss on investments	(455,000)
Net increase in net assets resulting from operations	$ 5,700

The accompanying notes are an integral part of these financial statements.

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* In the initial year of adopting a master-feeder structure, the feeder's statement of operations may be a combination of (*a*) direct income, expenses, and realized gains and losses for the period prior to adoption of the master-feeder structure, and (*b*) the allocated amounts from the master portfolio for the period from adoption to fiscal year end.

** Any expense waivers should be reported in a note to the statement of operations.

Exhibit 5.4 (continued)

5.96

ABC Feeder Fund, Inc.
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 460,700	$ 369,000
Net realized gain on investments	865,000	750,000
Change in unrealized appreciation or depreciation	(1,320,000)	1,178,000
Net increase in net assets resulting from operations	5,700	2,297,000
Distributions to shareholders	(1,178,700)	(1,071,000)
Net increase from capital share transactions:		
Sold 147,000 and 207,000 shares	1,782,600	2,359,000
Distributions reinvested of 72,000 and 73,000 shares	880,000	820,000
Redeemed 20,700 and 13,000 shares	(250,000)	(150,000)
Net increase from capital share transactions	2,412,600	3,029,000
Total increase in net assets	1,239,600	4,255,000
Net assets: Beginning of year	13,880,000	9,625,000
End of year	$15,119,600	$13,880,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.4 (continued)

5.97

ABC Feeder Fund, Inc.
Notes to Financial Statements

[*The following notes are limited to illustrations of disclosures unique to feeder fund financial statements. Besides the disclosures presented below, notes for a feeder fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7. Exceptions to the standard chapter 7 disclosures would be the omission of notes relating to the master fund portfolio activity and expenses such as the advisory fee incurred, which are disclosed in the master fund financial statements.*]

1. Significant Accounting Policies

ABC Feeder Fund, Inc. (the Fund) is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The Fund invests substantially all of its assets in the ABC Master Portfolio, an open-end investment company that has the same investment objectives as the Fund. The financial statements of the ABC Master Portfolio, including the Schedule of Investments, are included elsewhere in this report and should be read with the Fund's financial statements. The percentage of ABC Master Portfolio owned by the Fund at December 31, 20X4, was 80 percent.

Valuation of investments. The Fund records its investment in ABC Master Portfolio at fair value. Valuation of securities held by ABC Master Portfolio is discussed in the notes to the ABC Master Portfolio financial statements included elsewhere in this report.

Investment income and expenses. The Fund records daily its proportionate share of the ABC Master Portfolio's income, expenses, and realized and unrealized gains and losses. In addition, the Fund accrues its own expenses.

Exhibit 5.4 (continued)

5.98

ABC Feeder Fund, Inc.
Financial Highlights

	20X4	20X3	20X2*
*Per share operating performance:***, ***			
Net asset value, beginning of year	$ 13.11	$ 11.75	$10.00
Income from investment operations:			
Net investment income	0.40	0.41	0.38
Net realized and unrealized gain (loss) on investment transactions	(0.39)	2.12	2.47
Total from investment operations	0.01	2.53	2.85
Less distributions	(1.02)	(1.17)	(1.10)
Net asset value, end of year	$ 12.10	$ 13.11	$11.75
Total return	0.08%	21.53%	28.50%
Percentages and supplemental data:			
Net assets, end of period (000s)	$15,119	$13,880	$9,625
Ratios to average net assets:***			
Expenses	2.25%	2.30%	2.32%†
Net investment income	3.21%	2.48%	2.58%†

The accompanying notes are an integral part of these financial statements.

* For the period from March 1, 20X2, the date of commencement of operations, to December 31, 20X2.

** Selected data for a share of capital stock outstanding throughout the year.

*** The per share amounts and percentages reflect income and expenses assuming inclusion of the Fund's proportionate share of the income and expenses of ABC Master Portfolio.

† Annualized.

Exhibit 5.5

5.99

ABC Master Portfolio
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investments in securities, at fair value, identified cost $18,674,000	$21,101,000
Cash	199,000
Deposits with brokers for securities sold short	1,555,000
Collateral for securities loaned, at fair value	620,000
Receivables:	
Dividends and interest	100,000
Investment securities sold	24,000
Other assets	26,000
Total assets	23,625,000
Liabilities	
Options written, at fair value (premiums received $110,000)	230,000
Securities sold short, at fair value (proceeds $1,555,000)	1,673,000
Demand loan payable to bank	2,000,000
Payable upon return of securities loaned	620,000
Due to broker—variation margin	10,000
Payables:	
Investment securities purchased	210,000
Other	12,000
Accrued expenses	8,000
Total liabilities	4,763,000
Net assets	$18,862,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.5 (continued)

5.100

ABC Master Portfolio
Statement of Operations
Year Ended December 31, 20X4

Investment income:	
Dividends (net of foreign withholding taxes of $20,000)	$ 742,000
Interest	209,000
Income from loaned securities—net	50,000
Total income	1,001,000
Expenses:	
Investment advisory fee	171,900
Interest	10,000
Professional fees	18,000
Custodian	13,100
Directors' fees	10,000
Dividends on securities sold short	3,000
Total expenses	226,000
Investment income—net	775,000
Realized and unrealized gain (loss) on investments:	
Net realized gain (loss) on investments	1,089,000
Net change in unrealized appreciation (depreciation) on investments	(1,649,000)
Net loss on investments	(560,000)
Net increase in net assets resulting from operations	$ 215,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.5 (continued)

5.101

ABC Master Portfolio
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 775,000	$ 492,000
Net realized gain on investments	1,089,000	1,000,000
Change in unrealized appreciation or (depreciation)	(1,649,000)	1,551,000
Net increase in net assets resulting from operations	215,000	3,043,000
Proceeds from contributions	3,000,000	5,000,000
Fair value of withdrawals	(2,145,000)	(2,751,000)
	855,000	2,249,000
Increase in net assets	1,070,000	5,292,000
Net assets:		
Beginning of year	17,792,000	12,500,000
End of year	$18,862,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

Exhibit 5.5 (continued)

5.102

ABC Master Portfolio
Notes to Financial Statements

[*The following notes are limited to illustrations of disclosures unique to master fund financial statements. Besides the disclosures presented below, notes for a master fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7. Exceptions to the standard chapter 7 disclosures would be the omission of notes regarding dividend distributions, capital share transactions, and distribution fees, each of which is disclosed in the financial statements of the feeder fund.*]

1. Significant Accounting Policies

ABC Master Portfolio (the Portfolio) is organized as a trust and is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The Declaration of Trust permits the Trustees to issue nontransferable interests in the Portfolio. For federal income tax purposes the Portfolio qualifies as a partnership, and each investor in the Portfolio is treated as the owner of its proportionate share of the net assets, income, expenses, and realized and unrealized gains and losses of the Portfolio. Accordingly, as a "pass-through" entity, the Portfolio pays no income dividends or capital gain distributions.

2. Federal Income Taxes

The Portfolio will be treated as a partnership for federal income tax purposes. As such, each investor in the Portfolio will be subject to taxation on its share of the Portfolio's ordinary income and capital gains. It is intended that the Portfolio's assets will be managed so an investor in the portfolio can satisfy the requirements of subchapter M of the Internal Revenue Code.

3. Financial Highlights

Financial highlights for the Portfolio for each period were as follows:

	20X4	*20X3*	*20X2**
Total return	1.21%	24.34%	31.20%
Ratios to average net assets:			
Expenses	1.23%	1.25%	1.27%**
Net investment income	4.23%	3.25%	3.34%**
Portfolio turnover rate	92%	80%	102%

* For the period from March 1, 20X2, the date of commencement of operations, to December 31, 20X2.

** Annualized.

Exhibit 5.6

5.103

FOF Fund, Inc.
Statement of Net Assets
September 30, 200Y

[The following sample financial statements are limited to matters directly related to funds of funds. The sample financial statements in chapters 5 and 7 should be consulted for relevant disclosures.]

Assets:	
204,100 shares FOF Growth Fund, Inc.	$2,046,762
182,633 shares FOF International Fund, Inc.	2,224,470
96,152 shares FOF Income Fund, Inc.	1,046,134
602,908 shares FOF Money Market Fund, Inc.	602,908
Total investments (cost $5,617,279)	5,920,274
Cash	9,000
Receivable for Fund shares sold	23,652
Other assets	2,710
Total assets	5,955,636
Liabilities:	
Payable for Fund shares repurchased	37,123
Accrued expenses	8,327
Total liabilities	45,450
Net assets (equivalent to $10.73 per share based on 550,810 shares of capital stock issued and outstanding; unlimited shares authorized)	$5,910,186
Components of net assets:	
Paid-in capital	$5,569,426
Distributable earnings	340,760
	$5,910,186

The accompanying notes are an integral part of these financial statements.

Exhibit 5.6 (continued)

5.104

FOF Fund, Inc.
Statement of Operations
Year Ended September 30, 200Y

Investment income:		
Dividends from investment company shares		$201,942
Expenses:		
Custodian and transfer agent fees	$ 22,560	
Professional fees	8,318	
Registration fees	1,040	
Directors' fees	1,982	
Total expenses		33,900
Net investment income		168,042
Realized and unrealized gain (loss) on investments:		
Realized gain on sales of investment company shares	$ 12,067	
Realized gain distributions from investment company shares	321,939	
Net realized gain		334,006
Change in unrealized appreciation (depreciation) on investments during the year		219,837
Net realized and unrealized gain		553,843
Net increase in net assets resulting from operations		$721,885

The accompanying notes are an integral part of these financial statements.

Exhibit 5.6 (continued)

5.105

FOF Fund, Inc.
Statements of Changes in Net Assets
Years Ended September 30, 200Y and 200X*

	200Y	*200X*
Increase (decrease) in net assets from:		
Net investment income	$ 168,042	$ 32,177
Net realized gain on investments	334,006	16,090
Change in net unrealized appreciation	219,837	83,158
	721,885	131,425
Distributions to shareholders	(484,617)	(27,933)
Capital share transactions—net	2,172,589	3,396,837
Net increase in net assets	2,409,857	3,500,329
Net assets:		
Beginning of year	3,500,329	—
End of year	$5,910,186	$3,500,329

The accompanying notes are an integral part of these financial statements.

* The Fund commenced operations on October 1, 200W.

5.106

FOF Fund, Inc.
Notes to Financial Statements

1. Significant Accounting Policies

FOF Fund, Inc. (the Fund) is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management investment company. The Fund invests solely in shares of other funds within the FOF Group of Mutual Funds with the objective of seeking high total return through investments allocated to diverse equity and fixed-income markets.

The following is a summary of significant accounting policies that are in conformity with generally accepted accounting principles and which are followed consistently by the Fund in the preparation of its financial statements. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

Security Valuation. Investments in funds within the FOF Group of Mutual Funds are valued at their net asset value as reported by the underlying funds.

Transaction Dates. Share transactions are recorded on the trade date. Dividend income and realized gain distributions from other funds are recognized on the ex-dividend date. Distributions to shareholders, which are determined in accordance with income tax regulations, are similarly recorded on the ex-dividend date. In determining the net gain or loss on securities sold, the cost of securities is determined on the identified cost basis.

Federal Income Taxes. The Fund's policy is to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Thus, no federal income tax provision is required.

2. Investment Transactions

Cost of purchases and proceeds of sales of shares of funds within the FOF Group of Mutual Funds (excluding FOF Money Market Fund, Inc.) for the year ended September 30, 200Y, were $2,482,315 and $336,232, respectively. At September 30, 200Y, the cost of investments for federal income tax purposes was $5,617,279 and gross unrealized appreciation was $302,995; there was no gross unrealized depreciation.

3. Investment Advisory Services and Other Transactions With Affiliates

The Fund receives investment management and advisory services, consisting principally of determining the allocation of the assets of the Fund among designated underlying funds, under a management agreement with FOF Investment Management, Inc. (the Manager). The Manager receives no compensation under this agreement; however, the Fund pays management fees and expenses to the Manager indirectly, as a shareholder in funds of the FOF Group of Mutual Funds. Additionally, each fund in which the Fund invests (except FOF Money Market Fund, Inc.) pays a distribution fee to FOF Distributors, Inc., the distributor of the Fund, in the amount of 0.25 percent of average annual net assets. The Fund pays no sales loads or similar compensation to FOF Distributors, Inc. to acquire shares of each fund in which it invests.

Because the underlying funds have varied expense and fee levels and the Fund may own different proportions of underlying funds at different times, the amount of fees and expenses incurred indirectly by the Fund will vary.

The Fund paid $1,982 to unaffiliated directors during the year ended September 30, 200Y. No compensation is paid to any Director or officer who is affiliated with the Manager.

4. Capital Share Transactions

Transactions in capital shares were as follows:

	Years Ended September 30,			
	200Y		*200X*	
	Shares	*Amount*	*Shares*	*Amount*
Shares sold	204,017	$2,077,520	354,695	$3,590,241
Shares issued in reinvestment of dividends	41,817	425,255	2,615	27,013
Shares redeemed	(30,948)	(330,186)	(21,386)	(220,417)
Net increase	214,886	$2,172,589	335,924	$3,396,837

5. Components of Capital

Components of capital on a federal income tax basis at September 30, 200Y, were as follows:

Paid-in capital	$5,569,426
Undistributed net investment income	11,460
Undistributed net realized gain	26,305
Unrealized appreciation	302,995
	$5,910,186

The tax character of distributions paid during the years ended September 30, 200Y, and 200X, was as follows:

	200Y	*200X*
Ordinary income	$160,826	$27,933
Long-term capital gain	323,791	—
	$484,617	$27,933

5.107

Financial Highlights

	Year Ended September 30, 20X4	20X3
Per share data (for a share outstanding throughout the period):		
Net investment income*	$ .38	$ .20
Net realized and unrealized (gain) loss on investments	1.04	.38
Total from investment operations	1.42	.58
Less: Distributions to shareholders	(1.11)	(.16)
Net increase (decrease)	.31	.42
Net asset value:		
Beginning of year‡	10.42	10.00
End of year	$10.73	$10.42
Total return	13.59%	5.86%
Net assets, end of year (000s)	$5,910	$3,501
Ratio of expenses to average net assets**	0.72%	0.89%***
Net investment income as a percentage of average net assets*	3.59%	1.96%***
Portfolio turnover rate	21%	5%

* Recognition of net investment income by the Fund is affected by the timing of the declaration of dividends by the underlying investment companies in which the Fund invests.

** Does not include expenses of the investment companies in which the Fund invests.

*** Annualized.

‡ Investment operations commenced on October 1, 20X2.

Chapter 6
Taxes

Overview

6.01 This chapter is intended to be used as educational background to the auditor and should not be considered a detailed explanation of the Internal Revenue Code of 1986, as amended (IRC), or the various regulations and rulings issued by the Internal Revenue Service (IRS) as applied to investment companies. Thus, the auditor should consult a tax adviser with respect to tax issues that arise in the course of an audit and should not attempt to resolve them based solely on the background information provided in this chapter.

6.02 This chapter has been divided into two sections to focus on distinct aspects of taxes for investment companies: "Financial Statements and Other Matters" and "Taxation of Regulated Investment Companies." Due to the extensive interrelationships between taxes and the underlying accounts or products, certain tax matters appear in other chapters, as follows:

Topic	*Paragraph Reference*
Dividends to shareholders and reinvestments	4.45
Characterization of dividends for financial statement purposes	7.33
Financial statement disclosures:	
— Status under subchapter M	7.71
— Capital loss carryforwards and post-October capital and currency loss deferrals	7.71
Multiple classes of shares:	
— Preferential dividends	5.10, 5.14
— Return of capital	5.17
Master-feeder funds:	
— Master tax qualification	5.19
— Master tax earnings allocation	5.20
— Feeder funds	5.6, 5.19
Tax-free business combinations	8.35, 8.37
Unit investment trusts	9.13, 9.14
Variable contracts	10.38–10.52

Financial Statements and Other Matters

Income Tax Expense

6.03 Federal income tax expense is not required for investment companies that qualify under subchapter M of the IRC, and that distribute all of their investment company taxable income and taxable realized gains from securities transactions. For investment companies that qualify as regulated investment companies (RICs) under the IRC, federal income taxes payable on security gains that the investment company elects to retain are accrued only on the last day of the tax year.[1] Only shareholders of record on the last day of the fiscal year are entitled to the credit for income taxes paid by the fund. Information regarding retained gains and taxes paid is sent to those shareholders, to enable them to report their proportionate share of the gains and taxes paid on their individual returns. Also, no expense for federal excise taxes is required if a fund timely distributes substantially all of its taxable ordinary income, calculated on a calendar-year basis, and substantially all of its taxable capital gains, calculated generally on the basis of a twelve-month period ending October 31. (See paragraph 6.77.) Excise taxes imposed on underdistributed income should be recorded when determinable.

6.04 Income tax expense related to net investment income and net realized gains on investments should be recorded when it is probable that an investment company subject to subchapter M of the IRC will not qualify under that subchapter. Some funds also may be required to record deferred tax expense if it is probable that the company will not qualify for a period longer than one year.

6.05 Some investment companies may be subject to state, local, or foreign taxes on net investment income and realized gains on a recurring basis. State, local, and foreign taxes, if payable, are reported on the accrual basis, including deferred taxes on the unrealized appreciation or depreciation of investments. A valuation allowance should be established for any deferred tax asset resulting from temporary differences related to unrealized depreciation that could result in deductible amounts in future years when the probability of realization of the tax benefit does not meet the "more likely than not" criterion of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes.*

Federal Income Tax Provisions Affecting Investment Accounts

6.06 In establishing investment policies, companies that qualify as RICs under subchapter M of the IRC should consider the requirements of subchapter M relating to diversification of assets, sources of income and realized gains, and similar matters. Those requirements are described later in this chapter.

Withholding Taxes

6.07 Whenever income tax is withheld from investment income at the source (typically foreign taxes), the amounts withheld that are not reclaimable should be accrued at the same time as the related income if the tax rate is fixed and known. If the tax withheld is reclaimable from the local tax authorities, it should be recorded as a receivable and not as an expense. If the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount becomes known.

Financial Statement Presentation

6.08 Taxes in certain foreign jurisdictions may be based on the net investment income and realized gains of the fund within that jurisdiction; the guidance in FASB Statement No. 109 is applicable to such taxes. Income tax expense is usually presented by investment companies under the separate income categories (such as investment income or realized and unrealized gains) to which it applies. Deferred income tax expense, if any, should be presented separately.

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[1] Securities and Exchange Commission (SEC), *Codification of Financial Reporting Policies*, section 404.6b.

Diversification of Assets

6.09 As noted in paragraph 8.43, the diversification requirements appearing in a fund's prospectus and specified in various Securities and Exchange Commission (SEC) rules and interpretations may differ from those in subchapter M, discussed later in this chapter.

Taxation of Regulated Investment Companies

General Discussion of the Taxation of RICs

6.10 This chapter discusses in general terms the requirements of the IRC for qualification and taxation as a RIC under subchapter M of the IRC,[2] as well as the excise tax on certain undistributed taxable income and certain other federal tax matters affecting investment companies. (Although many states and municipalities have adopted provisions similar to subchapter M, a discussion of state and local taxes is beyond the scope of this chapter, as is discussion of the tax aspects of investment companies formed as partnerships.) In designing the detailed audit program, the auditor should refer to the latest IRC, Treasury regulations, and IRS rulings, and applicable state laws to be certain that all requirements for qualification have been covered and to determine the need for accruing income, excise, or other taxes.

Taxation of a RIC's Taxable Income and Net Capital Gains

6.11 An investment company organized as a corporation or as a business trust is taxable as a corporation and, as such, is subject to federal income taxes and certain state and local taxes the same as any other domestic corporation. However, if the investment company is registered under the Investment Company Act of 1940 (the 1940 Act), it may elect to qualify under the IRC for special federal income tax treatment as a RIC, which allows it to deduct dividends paid to shareholders and to pass through tax-favored income, such as capital gains and tax-exempt income (see paragraph 6.39 through 6.50.) A dividend for this purpose is defined as a distribution of current or accumulated earnings and profits (E&P). Thus, an investment company distributing all of its income to its shareholders would have no taxable income and, therefore, no tax liability. If an investment company fails to qualify as a RIC, it will be taxed as a regular corporation. The deduction for dividends paid by the investment company will not be available, and all distributions out of E&P will be taxed as ordinary income to shareholders. The effects of failure to qualify may extend beyond the income tax consequences, as net asset values may be improperly stated in such situations.

6.12 Certain funds are organized as series funds. A series fund includes several portfolios, each of which may have a different investment objective. Series funds are required to treat each portfolio as a separate corporation for tax purposes.[3]

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[2] Subchapter M consists of sections 851 to 860L of the Internal Revenue Code of 1986, as amended (IRC), and provides special tax rules for regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), and financial asset securitization investment trusts (FASITs). The rules affecting RICs are found in sections 851 through 855 and 860 of the IRC.

[3] Section 851(g) of the IRC.

6.13 To determine if a RIC has a federal income tax liability, investment company taxable income and net capital gain must be computed separately. Investment company taxable income is regular taxable income modified by certain adjustments. The following are among those adjustments:

- Net capital gain (that is, net long-term capital gain for the taxable year in excess of any net short-term **capital loss** for such year) is excluded.[4]
- Net operating losses are not allowed as a deduction.[5]
- The corporate deduction for dividends received is not allowed.[6]
- The deduction for dividends paid is allowed.

6.14 Note that, although investment company taxable income excludes net capital gain, it includes net short-term capital gain in excess of net long-term capital loss. A net capital loss may be carried forward by a RIC to eight succeeding taxable years, but it may not be carried back. Capital losses that are carried forward are treated as short-term capital losses in the year to which they are carried and reduce capital gains that arise in such year. A RIC is prohibited from claiming a net operating loss deduction. An investment company, especially a new one, may incur a net investment loss that may be used to reduce net short-term capital gains. If the net investment loss exceeds short-term gains, it may not be carried forward and deducted as a net operating loss if the investment company elects to be a RIC in succeeding years.

6.15 In order for a RIC to eliminate federal income tax liability, it must distribute ordinary dividends to shareholders sufficient to offset investment company taxable income and capital gain dividends sufficient to offset net capital gain.

6.16 The RIC's investment company taxable income may be reduced to zero by dividends other than capital gain dividends and exempt-interest dividends paid to shareholders from a RIC's E&P. The RIC's net capital gain may be offset by a capital gain dividend paid by the RIC to its shareholders and designated in a written notice mailed within sixty days of the close of the RIC's taxable year in which such dividend is paid.[7] This notice must specify whether any portion of the dividend is from capital gain transactions of the RIC subject to a 20 percent or 25 percent tax rate or transactions that will qualify as IRC section 1202 gain distributions related to small business stock. A RIC may not reduce its net capital gain by dividends that have not been designated as capital gain dividends. Accordingly, although a RIC may have fully distributed its investment company taxable income and net capital gain, it may be subject to tax on its net capital gain if the dividends have not been properly designated. Distributions to shareholders are discussed in more detail in paragraphs 6.57 through 6.71.

6.17 An investment company that does not meet all of the RIC qualification requirements in a taxable year will be taxed as a regular corporation for that year and must comply with provisions in a subsequent year if it elects to be taxed as a RIC, as follows:

a. A regular corporation that elects to qualify as a RIC will be subject to a corporate-level tax on its net unrealized gains as if its assets had

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4 Section 852(b)(2)(A) of the IRC.

5 Section 852(b)(2)(B) of the IRC.

6 Section 852(b)(2)(C) of the IRC.

7 Section 852 (b)(3)(C) of the IRC.

been sold on the day before the first day of the fiscal year that the corporation qualifies to be taxed as a RIC.[8] This general rule is designed to prevent regular corporations with appreciated assets from qualifying as a RIC, selling the assets at a gain, and eliminating corporate-level tax by distributing all income to the shareholders of the RIC.

b. From the general rule discussed above, it might appear that a RIC disqualified in one taxable year but qualifying the next year would owe a corporate-level tax on its net unrealized gains. However, an exception to the general rule is provided stating that a previously qualifying RIC that fails to meet the requirements of the RIC tax provisions for a single taxable year usually will not be required to recognize net unrealized gain if it "re-qualifies" in the immediately succeeding tax year.[9]

c. A corporation that accumulates E&P in a year in which it is not taxed as a RIC is required to distribute such E&P before the end of its RIC year if it wishes to be taxed as a RIC in such year. This also includes non-RIC E&P acquired in a tax-free reorganization occurring before December 22, 1992.[10]

Taxation of Shareholder Distributions

6.18 A dividend is a distribution from current year E&P or E&P accumulated in prior years. E&P is determined by adjusting taxable income for items that constitute economic income or deductions although they do not affect taxable income.[11] Examples of these adjustments include tax-exempt income, amortization of organization costs, and federal income taxes. Capital loss carryforwards, expenses related to tax-exempt income, and capital loss in excess of capital gain arising in a taxable year do not reduce current E&P.[12]

6.19 Distributions from a RIC are reported to shareholders on Form 1099-DIV as—

a. Ordinary dividends, to the extent of the RIC's current or accumulated E&P.[13]

b. Nontaxable distributions (that is, return of capital), to the extent that distributions paid within a fiscal year exceed the RIC's current and accumulated E&P.[14]

c. Capital gains, to the extent properly designated in a written notice to shareholders.

6.20 If a RIC has made distributions during a taxable year in excess of its current and accumulated E&P, it is required to answer the question on page 3 of Form 1120-RIC appropriately, file Form 5452 with its Form 1120-RIC, and report the taxable and nontaxable components on Form 1099-DIV.

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[8] IRS Notice 88-19, 1988-1 C.B. 486.

[9] IRS Notice 88-96, 1988-2 C.B. 420.

[10] Treasury Regulations 1.852-12 and 1.312-6.

[11] Section 312 of the IRC.

[12] Section 852(c) of the IRC.

[13] Sections 301(c)(1) and 316 of the IRC.

[14] Section 301(c)(2) of the IRC.

6.21 A dividend from investment company taxable income may qualify in whole or in part for the dividends-received deduction available to corporate shareholders. Only a portion of the dividends paid by the RIC may be eligible for the dividends-received deduction if the qualifying dividends received by the RIC are less than the RIC's net income (see appendix C, part II).

6.22 For domestic equity securities acquired after March 1, 1986, a dividend does not qualify for the dividends-received deduction if the stock on which the dividend was paid is held for less than 46 days during the 90-day period that begins 45 days before the stock becomes ex-dividend with respect to the dividend (or, for certain preferred stock, less than 91 days during the 180-day period that begins 90 days before the stock becomes ex-dividend). The holding period generally is suspended for this purpose during any time that the RIC has diminished its risk of loss through hedging.[15]

6.23 The portion of the dividend qualifying for the dividends-received deduction must be designated in a written notice mailed to the shareholders within sixty days after the end of the RIC's tax year in which the dividend was paid.[16]

6.24 If, at the end of a RIC's tax year, more than 50 percent of the fair market value of its assets is invested in stock or securities of foreign corporations, the RIC may elect to "pass through" to its shareholders the creditable foreign income taxes that it has paid during the year and also the foreign source income earned by the fund.[17] A RIC that makes this election is not entitled to a tax deduction for the expense or a foreign tax credit. However, the fund is entitled to treat the foreign taxes passed through to shareholders as a **deemed dividend** (that is, as part of the dividends-paid deduction).

6.25 Shareholders must report as taxable income the gross income received from the RIC (increased by creditable foreign taxes), and are entitled to either a foreign tax credit (subject to certain limitations) or a deduction (subject to other limitations) for their allowable share of foreign taxes paid by the RIC and passed through to them.[18] To claim or pass through a foreign tax credit, a RIC must hold the stock for sixteen days within the thirty-day period beginning fifteen days before the ex-dividend date (forty-five days within the ninety-day period for certain preferred stock).[19] The holding period generally is suspended for this purpose during any time that the RIC has diminished its risk of loss through hedging. Foreign taxes paid by a RIC that do not qualify for the foreign tax credit do not increase the taxable income reported to the shareholders (that is, the RIC is allowed to deduct such taxes in computing its investment company taxable income).[20]

6.26 If a RIC does not qualify to pass through the foreign taxes to shareholders, the taxes are deductible by the RIC in determining its investment company taxable income.

6.27 The source of the income (by country) and foreign taxes must be designated by the fund in a written notice to its shareholders mailed within sixty days after the end of the RIC's tax year in which the dividend was paid.[21]

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[15] Section 246(c) of the IRC.

[16] Sections 854(b)(2) and 853(e) of the IRC.

[17] Section 853(a) of the IRC.

[18] Section 853(b)(2) of the IRC.

[19] Section 901(k) of the IRC.

[20] Section 853(e) of the IRC.

[21] Section 853(c) of the IRC.

6.28 A RIC that at the end of each quarter of its taxable year has at least 50 percent of its assets invested in tax-exempt obligations is eligible to distribute exempt-interest dividends to its shareholders. Exempt-interest dividends received by a shareholder are treated as tax-exempt income.[22]

6.29 The maximum amount identified as exempt-interest dividends may not exceed the net tax-exempt interest earned by the fund. Net tax-exempt interest is tax-exempt interest income reduced for the amortization of premium on tax-exempt bonds in the portfolio and also for fund expenses attributable to the production of its tax-exempt interest income. (Capital gains are excluded from this calculation.) Generally, an acceptable basis for allocation is the ratio of tax-exempt income to gross investment income (tax-exempt plus taxable).[23] The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.[24]

6.30 If distributions exceed net tax-exempt interest income and taxable income (if any), the excess may be taxable to shareholders as ordinary dividends rather than as a return of capital to the extent of E&P because amounts not allowable as deductions do not reduce E&P.[25] Any additional distributions in excess of E&P may constitute a return of capital.

6.31 If a fund is not qualified to pay exempt-interest dividends, its distributions will be fully taxable to its shareholders.

6.32 Net gain or loss realized on the sale of tax-exempt securities is treated as capital gain or loss, unless the market discount rules apply, in which case a portion of the gain may be ordinary taxable income.

6.33 An exempt-interest dividend must be designated as such in a written notice mailed to shareholders not later than sixty days after the end of the RIC's tax year in which the dividend was paid.[26]

6.34 A capital gain dividend is any dividend designated as such in a written notice mailed to shareholders not later than sixty days after the end of the RIC's tax year in which the dividend was paid. To the extent that the amount so designated exceeds the fund's net capital gain for the year, the excess may not be treated as a capital gain dividend.[27]

6.35 A capital gain dividend is generally treated as long-term capital gain by the shareholder regardless of the actual holding period of the shareholder's shares in the RIC.

6.36 A RIC may retain all or any portion of its net capital gain and elect to have shareholders include the gain in their taxable income as though a capital gain dividend had been paid. In such a case, the RIC will pay corporate income tax (currently 35 percent) on the undistributed net capital gain within thirty days of its year end and notify shareholders within sixty days of the RIC's tax year end of the allocable retained capital gain and related income tax paid. The gain is treated as long-term capital gain, and the tax is treated as a tax payment by the shareholders. Each shareholder is entitled to increase the

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[22] Section 852(b)(5) of the IRC.

[23] Section 265(a)(3) of the IRC.

[24] Section 171(a)(2).

[25] Section 852(c)(1).

[26] Section 852(b)(5)(A) of the IRC.

[27] Section 852(b)(3)(C) of the IRC.

basis of his or her shares by a percentage (currently 65 percent) of the deemed distribution.[28] Notification must be provided to shareholders on Form 2439.[29]

6.37 The RIC may also retain all or any portion of the net capital gain and pay the income tax thereon without notifying shareholders. In this situation, the shareholders will not include the capital gain as income nor will they receive a credit for the taxes paid by the fund or an adjustment to the basis of their shares held.

6.38 A noncorporate taxpayer may exclude from taxable income 50 percent of capital gains resulting from the sale of certain qualified small business stock held for more than five years. To qualify for this exclusion, the stock must be acquired directly by the taxpayer (or indirectly, through the RIC in this case) at its original issuance after August 10, 1993, must be held by the RIC for more than five years, and the noncorporate taxpayer must hold shares of the RIC on the date the RIC acquired the qualified small business stock and at all times thereafter until disposition of the stock by the RIC.[30]

Qualification Tests

6.39 *Requirements for Qualification.* To qualify as a RIC for tax purposes, an investment company must—

a. Be a domestic corporation (or a business trust taxable as a corporation) registered for the entire taxable year under the 1940 Act.[31] An investment company is registered upon filing its notification of registration on Form N-8A.[32] Income earned before registration will cause a fund to fail to qualify as a RIC.

b. Elect, if it has not previously done so, to be taxed as a RIC.[33] To elect RIC status, an investment company prepares its tax return and computes taxable income in accordance with the provisions of subchapter M. Once elected, the company's status is unchanged as long as the company continues to qualify under the IRC.

c. Meet the 90 percent gross income test. (See paragraphs 6.42 through 6.45.)

d. Meet certain requirements concerning diversification of its total assets at the end of each quarter of the taxable year. (See paragraphs 6.46 through 6.50.)

6.40 In order for its distributions to be used to offset taxable income, the RIC must distribute at least 90 percent of its investment company taxable income (which includes net short-term capital gains, if any) and net tax-exempt income for the taxable year. (See paragraphs 6.57 through 6.60.)

6.41 A RIC should keep a record of the computations supporting qualification under the foregoing tests. (See appendix C.)

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28 Section 852(b)(3)(D)(iii).

29 Treasury Regulation 1.852-9.

30 Section 1202 of the IRC.

31 Section 851(a) of the IRC.

32 Each series of a series fund will be considered a registrant for this purpose.

33 Section 851(b)(1) of the IRC.

6.42 *90 Percent Gross Income Test (90 Percent Test).* A RIC must derive at least 90 percent of its gross income from dividends, interest, income from securities on loans, and gains (without including losses) from the sale or other disposition of stocks or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to the RIC's investing in such stock, securities, or currencies.[34]

6.43 Although the IRS may issue regulations that would exclude from qualifying income foreign currency gains that are not "directly related" to the RIC's principal business of investing in stock or securities (or options and futures with respect to stock or securities), no such guidance has been issued.

6.44 Gross income derived from a partnership (which is generally not what is reported on the partner's K-1 as taxable income and is not cash distributions received by the partner during the year) is treated by the RIC in the same manner as it would be if it were realized directly by the RIC for purposes of the 90 percent test.[35] Thus, gross income earned by a partnership other than income described in paragraph 6.42 would be treated by a RIC partner as nonqualifying income.

6.45 Other items of income, such as redemption fees, expense reimbursements, and lawsuit settlements, may require special consideration to determine their tax status and their effect on the 90 percent test. The IRS has ruled that if in the normal course of its business a RIC receives a reimbursement of investment advisory fees that was not the result of a transaction entered into to artificially inflate the RIC's qualifying gross income, such reimbursement may be considered qualifying income for purposes of the 90 percent test.[36]

50 Percent and 25 Percent Asset Diversification Tests

6.46 *50 Percent Test.* At the end of each quarter of the taxable year, at least 50 percent of the fair market value of the RIC's total assets must be represented by cash and cash items, U.S. government securities, securities of other RICs, and other securities. For this purpose, other securities do not include investments in the securities of any one issuer if they represent more than 5 percent of the fair market value of the investment company's total assets or more than 10 percent of the issuer's outstanding voting securities.[37]

6.47 *25 Percent Test.* At the end of each quarter of its fiscal year, not more than 25 percent of a RIC's total assets may be invested in the securities of any one issuer, except for the securities of the U.S. government or other RICs. This requirement also prohibits investing more than 25 percent of the RIC's total assets in two or more issuers that are controlled by the RIC and that are engaged in the same (or similar) or related trades or businesses.[38] For that purpose, the RIC controls the issuers if it has 20 percent or more of the combined voting power of each corporation.[39]

6.48 For purposes of the diversification tests, the issuer of an option or futures contract is the corporation or government that issued the underlying security. For index instruments, the IRS has concluded that the issuers of an

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[34] Section 851(b)(2) of the IRC.

[35] Section 851(b) of the IRC.

[36] Revenue Ruling 92-56.

[37] Section 851(b)(3)(A) of the IRC.

[38] Section 851(b)(3)(B) of the IRC.

[39] Section 851(c)(2) of the IRC.

option on a stock index are the issuers of the stocks or securities underlying the index, in proportion to the weighting of the stocks or securities in the computation of the index, regardless of whether the index is broad-based or narrow-based.[40] The IRS has not published guidance on the valuation of derivative instruments for purposes of this test.

6.49 A RIC that meets the asset diversification requirements at the end of its first taxable quarter, will not lose its status as a RIC if it fails to satisfy those requirements in a later taxable quarter, provided the noncompliance is due neither in whole or in part to the acquisition of a security or other property. If a RIC fails to meet the diversification requirements because of an acquisition, it may reestablish its status for such quarter by eliminating the discrepancy between the diversification requirements and its holdings within thirty days after the end of the quarter, using the securities' fair market values as of the end of the quarter.[41]

6.50 Special rules apply to an investment company that qualifies as a venture capital investment company.[42]

Variable Contracts

6.51 In addition to the diversification requirements applicable to all RICs (discussed above), special quarterly asset diversification tests are to be met by RICs used as investment vehicles for variable annuity, endowment, and life insurance contracts. These diversification requirements must be met on a calendar year basis without regard to the fiscal year of the fund. In general, a segregated asset account will be considered adequately diversified if—

a. No more than 55 percent of total assets is represented by any one investment.

b. No more than 70 percent of total assets is represented by any two investments.

c. No more than 80 percent of total assets is represented by any three investments.

d. No more than 90 percent of total assets is represented by any four investments.

In general, for a separate account to be permitted to "look through" to the assets of a RIC, all of the interests in the RIC must be held by one or more insurance company separate accounts.

6.52 All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment. Each governmental agency or instrumentality is treated as a separate issuer.

6.53 The IRS regulations provide a safe harbor for segregated asset accounts. If the segregated asset account meets the safe harbor test, it will be deemed as being diversified. The safe harbor test is met if a segregated asset account meets the RIC diversification tests, and the segregated asset account has no more than 55 percent of the value of its total assets invested in cash, cash items, government securities, and securities of other RICs.

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[40] General Counsel Memorandum (GCM) 39708 (March 4, 1988).

[41] Section 851(d) of the IRC.

[42] Section 851(e) of the IRC.

6.54 Special rules apply to a segregated asset account with respect to variable life insurance contracts.

6.55 If the diversification test is not met on the last day of a particular quarter, the separate account is allowed a thirty-day grace period after such quarter end to meet the diversification requirements. An exception is also available for certain separate accounts that are in the start-up mode, whereby accounts are considered diversified for the first year of their existence.

6.56 Failure of the underlying segregated asset accounts (separate accounts) to qualify will adversely affect the tax treatment of the variable annuity, endowment, or life insurance contracts. It will not directly affect the tax status of the RIC. However, asset diversification should be reviewed by the auditor and, if the test is not passed, the effect on financial statement disclosure must be considered.

Distribution Test

6.57 *90 Percent Distribution Test.* A RIC must pay dividends (exclusive of capital gain dividends) equal to the sum of 90 percent of investment company taxable income plus 90 percent of net tax-exempt income for the year. In addition, a corporation that has E&P from non-RIC years must distribute such E&P by the end of its first RIC year.[43]

6.58 For purposes of this distribution test, a RIC may elect to treat as paid on the last day of the fiscal year all or part of any dividends declared after the end of its taxable year. Such dividends must be declared before the due date for filing the corporate return, including any extensions. The dividends must be paid within twelve months after the end of the taxable year and not later than the date of payment of the first regular dividend after such declaration.[44]

6.59 If a RIC meets all of the qualification tests and the 90 percent distribution test but does not distribute all of its investment company taxable income, it must pay corporate income taxes on the undistributed portion. Similarly, if the company fails to distribute its net capital gains it is subject to tax on the undistributed gains.

6.60 A nondeductible excise tax on undistributed income is imposed on a RIC to the extent that the RIC does not satisfy certain distribution requirements for a calendar year. (See paragraphs 6.72 through 6.83.)

6.61 *Preferential Dividends.* A dividends-paid deduction is allowed only for distributions that are pro rata, with no preference as to any share of stock compared with any other share of the same class of stock.[45]

6.62 RICs may issue more than one class of stock. The principal tax issue arising with respect to this structure is whether or not the RIC has distributed preferential dividends to any of its shareholders. A RIC must allocate the various kinds of dividends it pays (such as tax-exempt interest, net capital gains, or the dividends-received deduction) proportionately among the classes of stock outstanding if more than one class of stock exists.[46] No deduction for dividends paid will be permitted to the extent that an excess amount has been

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[43] Section 852(a)(1) of the IRC.

[44] Section 855(a) of the IRC.

[45] Section 562(c) of the IRC and Treasury Regulation 1.562-2(a).

[46] Revenue Ruling 89-81, 1989-1 C.B. 226.

allocated to any one class. However, a RIC may specifically allocate certain expenses to a specific class of stock if it meets the requirements of IRC Revenue Procedure 96-47. Advisory fees and other fund-wide expenses must be allocated on a pro rata basis. IRC Revenue Procedure 99-40 provides guidance as to when expenses may be waived or reimbursed in a multi-class context.

6.63 *Distributions Made After December 31.* For purposes of a dividend deduction for the RIC and income recognition for the shareholder, distributions declared in October, November, or December payable to shareholders of record in such months and actually paid during January of the following year must be treated as having been paid on December 31 of the previous year to the extent of E&P.[47] This rule applies for both income and excise tax purposes.

6.64 A RIC may elect to treat as having been paid in the prior fiscal year (spillback or throwback) all or part of any dividends declared after the end of such taxable year. (See paragraph 6.58.) This election applies to regular dividends, capital gain dividends, and exempt-interest dividends. It affects only the RIC and does not change the year in which distributions are reported by the shareholders.

6.65 *Deficiency Dividends.* If a determination resulting from an IRS examination or court decision causes an increase in investment company taxable income, net capital gain, or a decrease in the deduction for dividends paid, the RIC may pay a **deficiency dividend** to protect its special status or avoid the payment of federal income tax.[48]

6.66 Interest and penalties usually are asserted as part of the deficiency-dividend procedure, which requires a payment within 90 days of the determination and the filing of a claim for deduction within 120 days of the determination.[49]

6.67 *Equalization Distributions.* An open-end investment company may use equalization accounting to prevent changes in the per share equity in its undistributed net income that may be caused by the continuous issuance and redemption of shares. Equalization for tax purposes differs substantially from book equalization because the calculation ignores contributions by purchasing shareholders (gross equalization credits).

6.68 A RIC is permitted to claim a dividends-paid deduction for the E&P associated with the redemption of shares (gross equalization debits).[50] Shareholders treat the entire redemption distribution as sales proceeds.

6.69 The theory of treating equalization payments as qualifying for the dividends-paid deduction is well established in the income tax rules. However, the precise method of calculating the E&P attributable to the redeemed shares is not particularly clear. One should take care to ensure that the most recent IRS pronouncements have been considered if equalization debits are to be used.

6.70 Equalization debits used as dividends may be used to satisfy the regular distribution requirements and also the excise tax distribution requirements.

6.71 *Capital Gain Dividends.* Any net capital loss or net long-term capital loss realized after October 31 is recognized in the next taxable year for purposes of designating capital gain dividends. The RIC may elect the same

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[47] Section 852(b)(7) of the IRC.

[48] Section 860(a) of the IRC.

[49] Section 860(c) of the IRC.

[50] Revenue Ruling 55-416, 1955-1 C.B. 416.

treatment for computing taxable income and E&P.[51] This deferral for designation purposes may be subject to bifurcation; that is, gains and losses in each capital gain category may be separately netted for the pre- and post-October 31 periods. For federal excise tax purposes, all post-October 31 capital gains and losses occur in the following excise tax year.[52]

Excise Tax on Undistributed Income

6.72 *Introduction.* A nondeductible excise tax on undistributed income is imposed on a RIC to the extent that the RIC does not satisfy certain distribution requirements for a calendar year (as shown below).

6.73 *Measurement Periods.* To determine the excise tax, a RIC's ordinary income and capital gain net income are measured separately.

6.74 Ordinary taxable income is defined as all income of the RIC during the calendar year other than gains or losses from the sale of capital assets.

6.75 Capital gain net income is the net of short-term and long-term gains and losses from sales or exchanges of capital assets generally computed for the one-year period ending on October 31.

6.76 RICs with fiscal years ending in November or December may elect to determine their capital gain net income as of the end of that fiscal year.[53]

6.77 *Calculation and Elections.* No excise tax is imposed if the RIC makes sufficient distributions during the calendar year. The required distribution consists of the following:

a. 98 percent of the ordinary income for the calendar year

b. 98 percent of the capital gain net income for the one-year period ending on October 31

c. 100 percent of the ordinary income or capital gain net income of the prior year that was not previously distributed[54]

6.78 Provided that the RIC distributes in aggregate an amount equal to the sum of the amounts listed above, the excise distribution requirement will be satisfied.

6.79 Any overdistribution (other than a return of capital) from the prior year may be applied to the required distribution of the current year.[55]

6.80 If a RIC retains a portion of its taxable income or gains and pays income tax on that amount, the amount will be treated as distributed for excise tax purposes. If a RIC distributes less than the minimum excise requirement, it must pay a 4 percent excise tax on the deficiency and include the amount on which the excise tax was imposed in the calculation of required distributions in the subsequent year.[56]

6.81 Ordinary income is equal to investment company taxable income measured on a calendar year basis after excluding net short-term capital gains with certain other adjustments such as the following:

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[51] IRS Notice 97-64.

[52] Treasury Regulation 1.852-11.

[53] Section 4982(e)(4) of the IRC.

[54] Section 4982(b) of the IRC.

[55] Section 4982(c)(2) of the IRC.

[56] Section 4982(c)(1) of the IRC.

- Tax-exempt interest and allocable expenses are not included in ordinary income.
- Although foreign currency gains and losses are treated as ordinary income or loss, they are measured for this purpose using the October 31 capital gain measurement period, unless the RIC has made the election referred to in 6.64 above.

Master-feeder arrangements require ratable inclusion of all items of income, gain, and loss. This should be contrasted with an investment in a partnership outside the master-feeder structure. In the latter case, partnership income is included in the measurement period that includes the year end of the partnership.

6.82 Capital gain net income includes long-term and short-term capital gains and losses. The **mark-to-market** rules for IRC section 1256 contracts and **passive foreign investment company** stock, the **wash sale** rules, and the **straddle** loss deferral rules are applied using October 31 as a year end (or November 30 or December 31 if a fiscal year election is made).[57] Note that marking of certain foreign currency forward contracts to market will result in ordinary income, which will be measured using October 31 as a year end. Capital loss carryovers computed using the excise tax measuring period may be used to reduce capital gain net income for purposes of the excise tax.[58] Capital gain net income may be reduced (but not below net capital gain) by the RIC's ordinary loss for the calendar year.[59]

6.83 *Exemption for Certain RICs.* Excise tax rules do not apply to a RIC if at all times during a calendar year each shareholder was either a qualified pension trust or a segregated asset account of a life insurance company held in connection with variable contracts. Shares owned by the investment adviser attributable to the **seed money** it contributed (up to $250,000) are not counted for this purpose.[60]

Computation of Taxable Income and Gains

6.84 *Dividends and Interest.* RICs record dividend income on the ex-dividend date for tax and accounting purposes.[61]

6.85 If a dividend or other distribution received by a RIC represents a return of capital, the basis of the security is reduced for tax purposes. If the distribution exceeds the RIC's tax basis in the security, the excess is treated as capital gain.[62]

6.86 Interest and original issue discount (OID) are accrued on a daily basis for tax and accounting purposes. However, differences in book and tax accounting for interest and OID related to complex securities and troubled debt securities may exist.

6.87 *Sales of Securities.* The basis of securities sold or otherwise disposed of may be either identified specifically or determined following a first in, first out (FIFO) convention; average cost may not be used for tax purposes. Identification procedures are prescribed in regulations.[63]

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[57] Tax Reform Act of 1986, H.R. Rep. No. 99-841, 99th Congress, 2d Sess. 243 (19).

[58] Tax Reform Act of 1986, H.R. Rep. No. 99-841, 99th Congress, 2d Sess. 243 (19).

[59] Section 4982(e)(2)(B) of the IRC.

[60] Section 4982(f) of the IRC.

[61] Section 852(b)(9) of the IRC.

[62] Section 301(c) of the IRC.

[63] Treasury Regulation 1.1012-1(c)(1).

6.88 Under the IRC, a wash sale occurs on a sale of securities (including options) if the seller acquires or enters a contract or option to acquire substantially identical securities within a period beginning thirty days before the date of a sale at a loss and ending thirty days after such date (sixty-one-day period). A loss resulting from such a transaction is deferred for tax purposes; the amount of the loss increases the tax basis of the new security purchased, and the holding period of the new position includes the holding period of the original position. However, a gain on the same type of transaction is taxable, and the tax basis of the new security is not affected by the sale of the old security.[64] Wash sale rules also apply to short-sale transactions such that the date a short sale is made, rather than the date of close, is considered in determining whether a wash sale has occurred.[65]

6.89 *Commissions.* Commissions related to purchases or sales of securities are not deductible but are added to the basis of the securities or offset against the selling price.[66]

6.90 *Bond Discount and Premium.* Special, detailed rules prescribe the calculation and treatment of discount and premium on taxable and tax-exempt securities. Although a discussion of these rules is beyond the scope of this Guide, the auditor should be aware that the application of these rules may affect the recognition and characterization of income and the deductibility of interest expense for tax purposes.

6.91 *Section 1256 Contracts.* Certain financial instruments ("section 1256 contracts") held by a RIC may be subject to mark-to-market rules. Section 1256 contracts generally include regulated futures contracts, certain foreign currency contracts, and options traded on (or subject to the rules of) a qualified board or exchange that are not equity options. Under these detailed rules, a RIC is treated for tax purposes as selling any section 1256 contract held on the last day of its taxable year for its fair market value. Gain or loss on an actual or deemed disposition of a section 1256 contract is treated as 40 percent short-term capital gain or loss and 60 percent long-term capital gain or loss, regardless of the holding period for the 1256 contract.[67] A detailed discussion of these rules is beyond the scope of this Guide.

6.92 *Tax Straddles.* The term "straddle" describes offsetting positions in personal property in which the fair market value of each position is expected to fluctuate inversely to that of the other. The term "position" means an interest (including a futures or forward contract or option) in personal property. An offsetting position occurs whenever risk of loss has been substantially diminished by holding one or more other positions.

6.93 The straddle rules provide that a loss from any position shall be recognized only to the extent that such loss exceeds the unrecognized gain with respect to one or more offsetting positions.[68] Although a detailed discussion of the straddle rules is beyond the scope of this Guide, the auditor should be aware that funds that engage in hedging may have significant book versus tax differences in capital gains or losses as a result of the straddle rules.

6.94 *Stock Issuance Costs.* Stock issuance costs paid by an open-end investment company are deductible for tax purposes except for costs incurred

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[64] Section 1091 of the IRC.

[65] Treasury Regulation 1.1091-1(g).

[66] Treasury Regulation 1.263(a)-2(e).

[67] Section 1256 of the IRC.

[68] Section 1092 of the IRC.

during the initial stock offering period. This also applies to 12b-1 fees.[69] Registration fees and expenses, including accounting procedures, are discussed in further detail in chapter 8.

6.95 *Stock Redemption Costs.* Stock redemption costs of an open-end investment company are deductible in computing investment company taxable income. Stock redemption costs of a closed-end investment company paid or incurred after February 28, 1986, are not deductible.[70]

6.96 *Capital Loss Carryforwards.* Capital losses may be carried forward for a period of eight years. However, the capital loss carryforward of a RIC may be further limited in the years after a tax-free reorganization where the assets of one RIC are acquired by another RIC.

6.97 *Section 988 Transactions.* Special rules apply to the treatment of foreign currency gains and losses attributable to "section 988 transactions." Foreign currency gains and losses from such transactions are treated as U.S.-source ordinary income or loss.[71]

6.98 A foreign currency gain or loss will result from a section 988 transaction described below denominated in a currency other than the RIC's functional currency (nonfunctional currency), or the fair market value of which is determined by reference to nonfunctional currency:

- *a.* Acquiring a debt instrument or becoming the obligor under a debt instrument
- *b.* Accruing any item of expense or gross income or receipt that is to be paid or received at a later date
- *c.* Entering or acquiring any forward contract, futures contract, option, or similar financial instrument
- *d.* Disposing of any nonfunctional currency[72]

6.99 The functional currency is the currency of the economic environment in which the RIC's operations are predominantly conducted and the currency used in keeping its books and records. The functional currency of a RIC is generally the U.S. dollar. Certain country funds may have a functional currency other than the dollar.[73]

6.100 Interest income or expense (including OID and discount on certain short-term obligations) on a nonfunctional currency debt instrument is determined in units of nonfunctional currency and translated into functional currency at the average exchange rate for the accrual period for accrual-basis RICs.

6.101 Foreign currency gain realized on the disposition of a section 988 debt security will be recognized for tax purposes and treated as U.S.-source ordinary income to the extent of the lesser of the foreign currency gain or the overall gain realized. Similarly, if a foreign currency loss is realized in a section 988 transaction, it will be recognized for tax purposes and treated as a U.S.-source ordinary loss to the extent of the lesser of foreign currency loss or the overall loss realized.[74]

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[69] Revenue Rulings 73-463 and 94-70.

[70] Section 162(k) of the IRC.

[71] Section 988(a) of the IRC.

[72] Section 988(c)(1) of the IRC.

[73] Section 985(b) of the IRC and Treasury Regulation 1.985-1(f), Example 2.

[74] Section 988(b) of the IRC.

6.102 The acquisition of nonfunctional currency is treated as an acquisition of property[75] with a functional currency tax basis determined with reference to the spot contract exchange rate (spot rate). A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract.[76] The disposition or other use of nonfunctional currency will result in a section 988 transaction if it is exchanged for another nonfunctional currency or for functional currency.[77]

6.103 Although section 988 does not apply to transactions involving equity securities, any fluctuation in the exchange rate between the trade date and the settlement date of either a purchase or sale of an equity security will result in a foreign currency gain or loss because the payment of the settlement liability constitutes a section 988 transaction.[78]

6.104 The sale, closing, or settlement (including by taking or making delivery of currency) of any forward contract, futures contract, option, or other similar financial instrument denominated in (or the fair market value of which is determined by reference to) a nonfunctional currency results in ordinary income or loss unless the contract is a futures or listed option contract traded on a qualified board or exchange.[79] However, certain elections are available for these kinds of financial instruments that permit income or gain to be characterized differently. A detailed discussion of these rules is beyond the scope of this Guide.

6.105 The IRS has provided special rules for certain section 988(d) hedging transactions. Current regulations cover certain debt instruments the currency risk (or a portion thereof) of which is entirely eliminated through a qualified hedge, executory contracts that are hedged, and hedges of trade to settlement date receivables and payables arising due to the sale or purchase of stocks or securities traded on an established securities market. These regulations provide integrated treatment for section 988(d) hedging transactions. The IRS may also issue rulings to taxpayers regarding net hedging and anticipatory hedging methods.[80]

6.106 The timing of the recognition of gain or loss from contracts subject to both sections 988 and 1256 is governed by the rules of section 1256.[81] Such contracts, therefore, are marked-to-market at fiscal year end. The character of such gain or loss may be either ordinary or capital depending upon the kind of contract and whether certain elections are made.

6.107 Passive Foreign Investment Companies. If a RIC owns a corporation that is treated as a passive foreign investment company (PFIC) for U.S. tax purposes, the fund may be subject to a corporate level tax and an interest charge on distributions received from the PFIC and gains realized on the sale of the PFIC holding. This is true even if the RIC has met its distribution requirements for the year. The PFIC provisions are included in sections 1291 through 1298 of the IRC.

6.108 The intent of the PFIC legislation was to prevent U.S. taxpayers from deferring taxes by buying foreign investment companies, which are not

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[75] Treasury Regulation 1.988-1(a).

[76] Treasury Regulation 1.988-1(b).

[77] Treasury Regulation 1.988-2(a).

[78] Treasury Regulation 1.988-2(a)(2).

[79] Treasury Regulation 1.988-2(a).

[80] Treasury Regulation 1.988-5.

[81] Treasury Regulation 1.988-2(d).

subject to U.S. income tax and which do not pay dividends. The effect of the PFIC rules is to require U.S. taxpayers to pay taxes as if the foreign company made a taxable distribution of all of its income and appreciation each year.

6.109 A foreign corporation is a PFIC if 75 percent or more of the corporation's gross income is "passive income" or if 50 percent or more of the foreign corporation's assets produce passive income. Passive income includes dividends, interest, royalties, rents, annuities, and net gains from the sale of securities, foreign currency, and certain commodity transactions that are not realized from an active trade or business. Examples of passive assets include cash (even if maintained for working capital requirements), stocks, bonds and other securities.

6.110 A RIC that owns a PFIC may still be able to avoid a corporate level tax and an interest charge if the RIC elects to treat the PFIC as a qualified electing fund (QEF). If this election is made, the RIC will be required to include in its taxable income its share of the PFIC's ordinary income and capital gain each year. The earnings of the QEF must be determined based on U.S. tax principles making it difficult for many foreign corporations to provide the necessary information.

6.111 The RIC may also elect to mark the PFIC to market each year and treat increases in unrealized appreciation (and decreases to the extent increases have been included previously) as part of its taxable income subject to distribution. If the RIC complies with these provisions it will avoid tax and interest charges.

6.112 Both the QEF and mark-to-market elections may result in the RIC having to make distributions of income it has not yet received.

6.113 A failure to make either of these elections may subject the RIC to corporate tax, in which case the recording of a tax liability should be considered. Thus, it is important to determine that RICs holding foreign securities have policies and procedures to identify PFICs timely.

Offshore Funds

6.114 In recent years the number of funds that are organized offshore (offshore funds) has increased substantially. This has occurred as U.S. fund advisers sought to globalize their customer base, and as foreign institutions increased their investments in U.S. securities.

6.115 A myriad of U.S. and foreign tax issues are associated with offshore funds. These funds are typically organized in the form that is most suitable for the expected owners. Further, they are located in the jurisdiction that provides the most beneficial taxation and regulation of the entity, taxation of owners, and withholding tax treatment for income earned and distributions made.

6.116 Offshore funds are usually not subject to income taxes imposed by the country in which they are domiciled. However, they are generally subject to U.S. withholding tax on dividends from U.S. stock holdings. They are not subject to U.S. income tax provided they are structured in such a way that they are not considered "engaged in a U.S. trade or business" for U.S. tax purposes. The Taxpayer Relief Act of 1997 repealed a tax rule requiring that certain activities, formerly referred to as the "10 Commandments," be performed outside of the United States. Some states may still require compliance with state rules similar to the federal "10 Commandments."

6.117 Due to their complex nature, U.S. and local country tax and regulatory considerations must be examined thoroughly for each offshore fund. An offshore fund subject to U.S. tax cannot elect to be treated as a RIC.

6.118 Offshore funds should have tax policies and procedures addressing taxation of the fund in the offshore country in which the fund is domiciled, the taxation of the fund's portfolio securities in the country in which the securities are taxed, and the taxation of fund shareholders in the countries in which they reside.

Small Business Investment Companies

6.119 Small business investment companies (SBICs) formed as corporations are generally subject to the corporate tax rules unless they qualify and elect to be treated as RICs.

6.120 An SBIC operating under the Small Business Investment Act of 1958 (the 1958 Act) receives special tax treatment. It is allowed a 100 percent deduction for dividends received that qualify for the dividend received deduction unless it elects to be taxed as a RIC.[82] In addition, it may be excluded from the definition of a **personal holding company**.[83]

6.121 A shareholder in an SBIC operating under the 1958 Act may treat a loss on its stock as an ordinary loss. In computing the net operating loss deduction, such a loss is treated as a loss from a trade or business.[84]

6.122 The tax rules permit special treatment for investors, including investment companies, in other forms of SBICs. Investors in small business corporations may qualify for ordinary loss treatment on the sale of their shares.[85] Investors in qualified small business stock may qualify for a 50 percent exclusion from gross income on the sale of small business stock.[86] Investors may also defer recognition of gain on sales of publicly traded securities by rolling over the proceeds into a specialized small business investment company (SSBIC).[87]

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[82] Section 243(a)(2) of the IRC.

[83] Section 542(c)(8) of the IRC.

[84] Section 1242 of the IRC.

[85] Section 1244 of the IRC.

[86] Section 1202 of the IRC.

[87] Section 1044 of the IRC.

Chapter 7

Financial Statements of Investment Companies

7.01 The overall objective of financial statements, including financial highlights, of investment companies is to present net assets, results of operations, changes in net assets, and financial highlights resulting from investment activities and, if applicable, from capital share transactions. In addition to complying with generally accepted accounting principles (GAAP), the financial statements of investment companies registered with the Securities and Exchange Commission (SEC) should comply with applicable SEC requirements. In reporting to shareholders, investment companies and SEC-registered investment companies should present financial statements and financial highlights as follows.

*Nonregistered Investment Companies**	*Registered Investment Companies*
A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein, as of the close of the latest period. At a minimum, a condensed schedule of investments (as discussed in paragraphs 7.12 and 7.13) should be provided for each statement of assets and liabilities.	A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein (that is, a detailed list of investments in securities, options written, securities sold short, and other investments) as of the close of the latest period.[1] A schedule of investments should be provided for each statement of assets and liabilities in conformity with rule 12-12 of Regulation S-X.
A statement of operations for the latest period.	A statement of operations for the latest year.[1, 2]
A statement of cash flows for the latest period (if not exempted by Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*).	A statement of cash flows for the latest year (if not exempted by FASB Statement No. 102).[1, 2]
A statement of changes in net assets for the latest period.	A statement of changes in net assets for the latest two years (for semiannual reports, the most recent semiannual period and preceding fiscal year).[1, 2]

(continued)

Nonregistered Investment Companies[*]	*Registered Investment Companies*
Financial highlights for the latest period consisting of per share operating performance, net investment income, and expense ratios and total return for all investment companies organized in a manner using unitized net asset value.[3]	Financial highlights for the latest five fiscal years[1, 2, 4] (for semiannual reports, the semiannual period and generally the preceding five fiscal years).

7.02 The financial statements illustrated in this chapter are for typical open-end management investment companies and may need to be modified to fit the requirements of other types of investment companies. Financial reporting requirements with respect to unit investment trusts and variable annuity separate accounts are discussed in chapters 9 and 10 of this Guide. For guidance on financial statement presentation and disclosure of venture capital and small business investment companies, including additional regulatory requirements, refer to appendix A. Aspects of reporting on interim financial information are discussed in paragraphs 7.72 through 7.74.

7.03 Financial statements and related disclosures shall be presented for each series in a series fund although one or more series may be presented in a separate document.[5] For funds with multiple classes of shares, certain infor-

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[*] In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships,* that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

A final pronouncement is expected to be issued in the fourth quarter of 2003. A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

[1] If the most current statement of assets and liabilities included in a registration statement is as of a date more than 245 days prior to the date the filing is expected to become effective, then the financial statements, which may be unaudited, included in such filing are to be updated to a date within 245 days of the expected effective date. A statement of assets and liabilities as of such date must be provided as well as a statement of operations, cash flows (if applicable), and statement of changes in net assets for the interim period from the end of the most recent fiscal year for which a statement of assets and liabilities is presented and the date of the most recent interim statement of assets and liabilities.

[2] The Securities and Exchange Commission (SEC) staff currently requires that sufficient fiscal periods be presented to cover at least twelve calendar months' results of operations ending on the most recent fiscal year-end date (twenty-four calendar months' changes in net assets; sixty months' financial highlights).

[3] For investment companies not using unitized net asset value, financial highlights should be presented and consist of net investment income and expense ratios and total return.

[4] Item 9(a) of Form N-1A requires financial highlights to be presented for the latest five years in the fund's prospectus. Item 4 of Form N-2 requires financial highlights to be presented for the latest ten years in the fund's prospectus.

[5] Rule 6.03(j) of Regulation S-X.

mation relating to each class is required to be disclosed as discussed in chapter 5 of this Guide.

Consolidation by Investment Companies*

7.04 Except as discussed in paragraph 7.05, consolidation or use of the equity method of accounting by an investment company of a non-investment company investee is not appropriate. Regulation S-X, rule 6-03(c)(1) precludes consolidation by a registered investment company of any entity other than another investment company. Similarly, Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, does not apply to "investments in common stock held by investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly."

7.05 The only exception to this general principle occurs if the investment company has an investment in an operating company that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an individual investment company holds a controlling interest in such an operating company, consolidation is appropriate. If an investment company holds a noncontrolling ownership interest in such an operating company that otherwise qualifies for use of the equity method of accounting, the investment company should use the equity method of accounting for that investment, rather than the fair value of the investee's assets and liabilities.

7.06 Public investment companies organized pursuant to master-feeder arrangements, as defined by the SEC,[6] must provide master financial statements with each feeder financial statement pursuant to SEC requirements. Nonpublic investment companies may follow the provisions of Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2,*

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* In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, an interpretation of ARB No. 51. Until the issuance of this Interpretation, investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. FASB Interpretation No. 46 would change the model for determining when to consolidate a controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. The Interpretation would also require disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company. In August 2003, the FASB Board has directed the FASB staff to issue a FASB Staff Position delaying the effective date of FASB Interpretation No. 46 for investment companies not subject to SEC Regulation S-X, Rule 6-03(c)(1) that are currently accounting for their investments in accordance with the specialized accounting guidance in this Guide. The deferral would not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity. The FASB Board decided to delay the effective date for these parties while the AICPA finalizes its proposed SOP on the clarification of the scope of this Guide and accounting by the parent companies and equity method investors for investments in investment companies. When the AICPA issues the final SOP, the FASB Board will consider modifying paragraph 4(e) of FASB Interpretation No. 46 to provide an exception for companies that apply the Guide as revised by the SOP. Readers should be alert for any additional action by the FASB and the ultimate impact FASB Interpretation No. 46 may have on non-registered investment companies.

[6] The SEC defines a master-feeder arrangement as a registered investment company that invests in a single investment vehicle.

Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*, or may present a complete set of master financial statements with each feeder financial statement, in a manner that is consistent with the requirements for public investment companies.

Reporting Financial Position

7.07 Investment companies report financial position by presenting either a statement of assets and liabilities or a statement of net assets. Regulation S-X provides that a statement of net assets may be presented if the amount of investments in securities of unaffiliated issuers is greater than 95 percent of total assets.[7]

7.08 The statement of assets and liabilities presents a list of assets and liabilities, and an amount for net assets equal to the difference between the totals. A separate schedule of investments is required as described in paragraphs 7.10 through 7.13.

7.09 The statement of net assets includes a schedule of investments. Details of related-party balances and other assets and liabilities should be presented in the statement of net assets or in the notes to the financial statements. Rule 6.05 of Regulation S-X includes additional disclosures for registered investment companies. Net asset value per share for each class of shares of capital stock outstanding should be presented as noted in chapter 5.

Schedule of Investments

7.10 In the absence of regulatory requirements,[8] investment companies should—

a. Disclose the name, share, or principal amount of—

(1) Each investment (including short sales, written options, futures, forwards, and other investment-related liabilities) whose fair value constitutes more than 1 percent of net assets.

(2) All investments in any one issuer whose fair values aggregate more than 1 percent of net assets.

(3) At a minimum, the fifty largest investments.

In applying the 1-percent test, total long and total short positions in any one issuer should be considered separately.

b. Categorize investments by—

(1) The type of investment (such as common stocks, preferred stocks, convertible securities, **fixed income securities**, government securities, options purchased, options written, warrants,

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[7] Rule 6.05 of Regulation S-X.

[8] Rules 6.03, 6.04, 6.05, 12-12, 12-12A, 12-12B, 12-13, and 12-14 of Regulation S-X apply to registered investment companies.

In December 2002 the SEC proposed for comment amendments to Regulation S-X which would permit most investment companies to provide summarized schedules of investments in shareholder reports, under requirements similar to those described in this paragraph, along with tabular or graphical data on the industry, geographic, credit quality, or maturity profiles of the portfolio. Money market funds operating under SEC Rule 2a-7 would be allowed to completely omit a schedule of investments from their shareholder reports. A complete schedule of investments would continue to be required to be filed in Form N-CSR and to be made available to shareholders upon request. See SEC Release No. IC-25870 for more information. Readers should be alert of any final rule.

futures, loan participations and assignments, short-term securities, repurchase agreements, short sales, forwards, other investment companies, and so forth).

(2) The related industry, country, or geographic region of the investment.

As required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in addition to the categorization chosen above, any other significant concentration of credit risk should be reported in a summarized manner. For example, an international fund that categorizes its investments by industry or geographic region should also report a summary of its investments by country, if such concentration is significant.

Additionally, as contemplated by the requirement to disclose certain significant estimates in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, the use of estimates by directors, general partners, or others in an equivalent capacity to value securities, should be reported in a summarized manner.

c. Disclose the aggregate other investments (each of which are not required to be disclosed by (*a*) above) without specifically identifying the issuers of such investments, and categorize as required by (*b*) above—

(1) The percent of net assets that each such category represents.

(2) The total value for category in (*b*)(1) and (*b*)(2).

7.11 For public registrants, disclosure relating to repurchase agreements should include the parties to the agreement, the date of the agreement to repurchase, the interest rate, the total amount to be received upon repurchase, and a brief description of the nature and terms of the collateral.[9] Public registrants are also required to disclose investments in restricted securities, affiliated companies, securities subject to call options, and when-issued securities in the schedule of investments; disclosure of specific information in the notes to the financial statements may also be required by other authoritative pronouncements.[10] The SEC also requires that each security that is non-income producing should be identified as such.[11] Securities pledged as collateral should be identified.[12] Where a detailed list of short-term investments is presented, such investments may be summarized by issuer, disclosing their ranges of interest rates and maturity dates.*

[9] Rule 12.12 of Regulation S-X requires that each issue shall be listed separately.

[10] For specific requirements concerning disclosures of information relating to restricted securities and affiliated companies, see SEC's *Codification of Financial Reporting Policies*, sections 404.03 and 404.04, and rule 12-14 of Regulation S-X.

[11] Rule 12.12 of Regulation S-X.

[12] Rule 4.08(b) of Regulation S-X.

* In December 2002, the SEC proposed for comment amendments to Regulation S-X which would permit most investment companies to provide summarized schedules of investments in shareholder reports, under requirements similar to those described in this paragraph, along with tabular or graphical data on the industry, geographic, credit quality, or maturity profiles of the portfolio. Money market funds operating under SEC Rule 2a-7 would be allowed to completely omit a schedule of investments from their shareholder reports. A complete schedule of investments would continue to be required to be filed in Form N-CSR and to be made available to shareholders upon request. See SEC Release No. IC-25870 for more information. Readers should be alert of any final rule.

7.12 Investment partnerships[13] *that are exempt from SEC registration* under the Investment Company Act of 1940 (the 1940 Act) [*] should—

a. Categorize investments by the following:

(1) Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)

(2) Country or geographic region

(3) Industry

Report the percent of net assets that each such category represents and the total value and cost for each category in (*a*)(1) and (*a*)(2).

b. Disclose the name, shares or principal amount, value, and type of the following:

(1) Each investment (including short sales), constituting more than 5 percent of net assets

(2) All investments in any one issuer aggregating more than 5 percent of net assets

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by (*a*) above.[14]

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[13] Included are **hedge funds**, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics, and commodity pools subject to regulation under the Commodity Exchange Act of 1974. Excluded are investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner.

[*] In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

A final pronouncement is expected to be issued in the fourth quarter of 2003. A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

[14] In April 2003, the AICPA Auditing Standards Board issued Auditing Interpretation No. 16 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508), entitled "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940." According to this Interpretation, if financial statements of an investment partnership that is exempt from SEC registration do not include the required Schedule of Investments disclosures that are listed in this paragraph, and it is practicable for the auditor to determine them or any portion thereof, the auditor should include the information in his or her report expressing the qualified or adverse opinion. See paragraphs 11.03–11.05 for more information.

7.13 Investments in other investment companies (investees), such as investment partnerships, limited liability companies, and funds of funds, should be considered investments for purposes of applying paragraphs 7.10(*a*) and (*b*) and 7.12. If the reporting investment company's proportional share of any investment owned by any individual investee exceeds 5 percent of the reporting company's net assets at the reporting date, each such investment should be named and categorized as discussed in paragraph 7.12. If information about the investee's portfolio is not available, that fact shall be disclosed. These investee disclosures should be made either in the condensed schedule of investments (as components of the investment in the investee) or in a note to that schedule.

7.14 Credit enhancements should be shown as a component of the security description in the schedule of investments. Separate disclosure of a credit enhancement should be provided on the face of the schedule of investments, and should comply with rules 6.04.1 and 6.04.3 of Regulation S-X, where applicable. The terms, conditions, and other arrangements relating to the enhancement should be disclosed in the notes to the financial statements. In addition, for a put option provided by an affiliate, the schedule of investments should describe the put as from an affiliate and the notes to financial statements should include the name and relationship of the affiliate. For a letter of credit, the name of the institution issuing the letter of credit should be disclosed separately.

Assets

7.15 Following are the major asset categories reported in a statement of assets and liabilities and statement of net assets.

7.16 *Investments in Securities.* The general practice in the investment company industry is to report investments in securities as the first asset because of their relative importance to total assets. *Securities,* as used in this Guide, includes but is not limited to stocks, bonds, debentures, notes, rights, warrants, certificates of interest or participation in equity or debt instruments, U.S. government securities, bank **certificates of deposit**, **banker's acceptances**, **commercial paper**, repurchase agreements, purchased options, and tranches of fixed income securities (such as interest-only and principal-only investments).

7.17 Investment companies should report their securities in financial statements at fair value. Investments in foreign securities should be reported at fair value by converting their foreign currency denominated value into the functional currency using current exchange rates.

7.18 *Cash.* Cash on hand and demand deposits are included under the general caption *cash.* Amounts held in foreign currencies should be disclosed separately at value, with acquisition cost shown parenthetically. Time deposits and other funds subject to withdrawal or usage restrictions should be presented separately from other cash amounts.[15] Applicable interest rates and maturity dates should be disclosed.

7.19 *Receivables.* Receivables are usually listed separately at net realizable value for each of the following categories, among others:[16]

- Dividends and interest
- Investment securities sold
- Capital stock sold

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[15] Rule 5.02.1 of Regulation S-X.

[16] Rule 6.04 of Regulation S-X.

- Other accounts receivable, such as receivables from related parties, including expense reimbursement receivables from affiliates, and **variation margin** on open futures contracts

Receivables denominated in foreign currencies should be converted into the functional currency at current exchange rates and may be categorized with the corresponding functional currency receivables.

7.20 *Other Assets.* Deferred offering costs, prepaid taxes, and prepaid insurance are normally included under this caption. Separate amounts are usually not reported unless significant. For public registrants, amounts held by others in connection with short sales, option contracts, financial futures contracts, and collateral received for securities loaned[17] should be stated separately. FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, states that, with respect to forward foreign exchange contracts, swaps, options, and similar contracts, unless specified conditions are met, the fair value of contracts in loss positions should not be offset against the fair value of contracts in gain positions.

Liabilities

7.21 The following categories of liabilities are reported in the statement of assets and liabilities.

7.22 *Accounts Payable.* Accounts payable is usually listed separately for investment securities purchased and capital stock reacquired.

7.23 *Call or Put Options Written, Futures Contracts Sold, and Securities Sold Short.* Call or put options written and securities sold short at the close of the period should be presented separately at fair value in the statement of assets and liabilities, with premiums received on written options and proceeds from short sales disclosed parenthetically. Variation margin due to a broker on futures contracts should be disclosed separately, if significant. Details of the securities sold short, options written, and futures contracts sold should include information about quantities, fair values, and proceeds and should be presented within the schedule of investments, as discussed in paragraph 7.10. Information presented for options written should include the number of shares or principal amount, the fair value of each option, the strike price, and the exercise date.

7.24 *Accrued Liabilities.* Accrued liabilities includes liabilities for management fees, distribution fees, interest, compensation, taxes, and other expenses incurred in the normal course of operations. Separate disclosure is required for related-party payables.

7.25 *Notes Payable and Other Debt.* Notes payable to banks, including bank overdrafts, and to others, and other debt should be stated at amounts payable, net of unamortized premium or discount, and reported separately. Information relating to unused lines of credit, conditions of credit agreements, and long-term debt maturities should be disclosed in the notes to the financial statements. The investment companies should also disclose the fair value of liabilities in accordance with the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

7.26 *Other Liabilities.* Other liabilities includes amounts due to counterparties for collateral on return of securities loaned, deferred income, and dividends and distributions payable. Payables denominated in foreign currencies should be converted into the functional currency at current exchange rates and may be categorized within the corresponding functional currency payables.

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[17] Rule 6.04.7 and 6.04.11 of Regulation S-X.

7.27 Paragraph 15 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, describes the accounting for noncash collateral by the debtor (obligor) and the secured party, which depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted. Cash collateral used in securities lending transactions shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing. Investment company securities lending transactions often entitle and obligate the transferor to repurchase or redeem the transferred assets before their maturity and the transferor, accordingly, maintains effective control over those assets. Those transactions shall be accounted for as secured borrowings, in which cash (or other securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

Net Assets

7.28 Shareholders' equity[*] includes amounts contributed by shareholders and distributable earnings. Distributable earnings represents the cumulative results of changes in net assets from operations, net of distributions to shareholders. The statement or the notes should disclose information about the following:[18]

a. Units of capital, including the title and par value of each class of capital shares or other capital units, the number authorized, the number outstanding, and dollar amount.

b. Paid-in capital, which includes the net proceeds received on the sale of capital shares less the cost of reacquired shares and return of capital distributions (that is, tax return of capital distributions; see paragraph 7.55). In addition, certain differences between GAAP-basis income or gain amounts and tax-basis amounts distributed from income or gain are reclassified to paid-in capital in the period in which such differences become permanent differences (see paragraph 7.55).

c. Distributable earnings (accumulated losses), which includes cumulative net investment income or loss, cumulative amounts of gains and losses realized from investment and foreign currency transactions, and net unrealized appreciation or depreciation of investments and foreign currencies, and distributions paid to shareholders other than tax return of capital distributions.

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[*] In May 2003, the FASB issued FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which becomes effective for financial instruments entered into or modified by a public entity after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. FASB Statement No. 150 becomes effective for both existing and new financial instruments issued by non-public entities for fiscal periods beginning after December 15, 2003. Under this Statement, mandatorily redeemable preferred stock should be classified as a liability, unless the redemption is required to occur upon liquidation or termination of the entity. While mutual fund shares are not mandatorily redeemable, other types of equity instruments should be considered under FASB Statement No. 150.

The FASB has indicated that a second phase of the project resulting in the issuance of Statement No. 150 will encompass broader aspects of classification of financial instruments between liabilities and equity, including all forms of conditionally-redeemable stock. The FASB intends to consider its project plan for the second phase of the project in July 2003.

[18] Rules 6.04.16 and .17 of Regulation S-X require such information to be included on the face of the statement of assets and liabilities, if such statement is presented.

d. The notes should disclose the tax-basis components of distributable earnings as of the most recent tax year end: undistributed ordinary income, undistributed long-term capital gains, capital loss carryforwards, and unrealized appreciation (depreciation). If a provision for deferred income taxes on unrealized appreciation exists, it should be charged against the unrealized gains account and disclosed as such in the statement of operations. Explanations should be provided for the differences between the total of these amounts and distributable earnings (accumulated losses).

7.29 Investment partnerships and other pass-through entities typically aggregate all elements of equity into partners' capital, because the results from operations are deemed distributed to each partner.

7.30 *Net Asset Value Per Share.* Net asset value per share is the amount of net assets attributable to each share of capital stock (other than **senior equity securities**, that is, preferred stock) outstanding at the close of the period. It excludes the effects of assuming conversion of outstanding convertible securities, whether or not their conversion would have a diluting effect. Net asset value per share should be disclosed for each class of shares.

7.31 Consistent with an SEC staff announcement published under EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, a registered investment company should not include preferred stock under the caption "Net assets" if the investment company may be required to redeem all or part of the preferred stock upon failure to satisfy statistical coverage requirements imposed by its governing documents or a rating agency. Recently, the Chief Accountants Office of the Division of Investment Management released more guidance specific to the application of Topic D-98 to closed-end funds. Of most significance, the staff indicated that distributions to preferred stockholders should be presented as a component of the net increase (decrease) in net assets resulting from investment operations, below net investment income on the statement of operations, the statement of changes in net assets and financial highlights. The staff indicated that preferred stock arrangements that are redeemable on a fixed or determinable date should follow the guidance set forth in EITF Topic D-98.*

Statement of Operations

7.32 The objective of the statement of operations is to present the increase or decrease in net assets resulting from all of the company's investment activities, by reporting investment income from dividends, interest, and other income less

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* In May 2003, the FASB issued FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which becomes effective for financial instruments entered into or modified by a public entity after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. FASB Statement No. 150 becomes effective for both existing and new financial instruments issued by non-public entities for fiscal periods beginning after December 15, 2003. Under this Statement, financial instruments which are mandatorily redeemable on a fixed date or upon the occurrence of an event certain to occur should be classified initially as liabilities. Contingently redeemable securities, such as those described in this paragraph, are not within the scope of FASB Statement No. 150 unless and until the contingency occurs, at which time the instruments should be reclassified as liabilities. Therefore, with respect to contingently redeemable securities for which the contingency has not occurred, the guidance in this paragraph should continue to be followed.

The FASB has indicated that a second phase of the project resulting in the issuance of FASB Statement No. 150 will encompass broader aspects of classification of financial instruments between liabilities and equity, including all forms of conditionally-redeemable stock. FASB intends to consider its project plan for the second phase of the project in July 2003.

expenses, the amounts of realized gains or losses from investment and foreign currency transactions, and changes in unrealized appreciation or depreciation of investments and foreign currency denominated assets and liabilities for the period. That format helps the user understand the contribution of each aspect of investment activity to the company's overall operations.

Investment Income

7.33 *Dividend Income.* Dividend income is recorded on the ex-dividend date. Dividends from affiliates and controlled companies should be disclosed.[19] (Chapter 2, "Investment Accounts," discusses noncash dividends, dividends in arrears on preferred stocks, and dividends from other than distributable earnings.)

7.34 *Interest Income.* Interest income (including amortization of premiums and discounts) is generally accrued on all debt securities. However, chapter 2 discusses special reporting requirements for interest on high-yield debt securities, bonds in default, and other kinds of securities such as payment-in-kind bonds and step bonds. Interest earned on securities of affiliates and controlled companies should be disclosed separately.

7.35 *Other Income.* Other income includes fee income from securities loaned and from miscellaneous sources. Individual items, if material, should be disclosed separately.

Expenses

7.36 Although expenses, either individually or in the aggregate, are seldom material to net assets or to changes in net assets, the following expenses are commonly reported separately:

a. Investment advisory (management) fees (or compensation)

b. Administration fees payable to an affiliate (if accrued under a separate agreement)

c. Shareholder service costs, including fees and expenses for the transfer agent and dividend disbursing agent

d. Distribution (12b-1) expenses (discussed in chapter 8)

e. Custodian fees

f. Cost of reports to shareholders

g. Federal and state income taxes. These expenses should be shown separately after the income category to which they apply, such as investment income and realized or unrealized gains. (Chapter 6 discusses the provision for taxes for companies that do not meet the requirements necessary to qualify as a regulated investment company.)

h. Other taxes (Foreign withholding taxes should be deducted from the relevant income item and disclosed parenthetically or shown as a separate contra item in the income section.)

i. Interest (including interest on debt, bank borrowings, and reverse repurchase agreements)

j. Dividends on securities sold short

k. Professional fees

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[19] Rule 6.07.1 of Regulation S-X for SEC registrants. Investment companies are required to comply with FASB Statement No. 57, *Related Party Disclosures*.

l. Directors' or trustees' fees

m. Registration fees and expenses (discussed in chapter 8)

Regulation S-X requires separate disclosure of each expense exceeding 5 percent of total expenses.

7.37 Amounts paid to affiliates or related parties (such as advisory fees, administration fees, distribution fees, brokerage commissions, and sales charges) should be disclosed in accordance with FASB Statement No. 57, *Related Party Disclosures*. Significant provisions of related-party agreements, including the basis for determining management, advisory, administration, or distribution fees, and also other amounts paid to affiliates or related parties, should be described in a note to the financial statements.

7.38 An adviser or a third party may voluntarily or involuntarily "waive" its fee and reimburse expenses (waivers). An example of an involuntary waiver is when the advisory agreement (or other regulation or agreements that are either outside the adviser's control or require shareholder approval) provides that the adviser should reimburse the investment company for expenses in excess of a specified percentage of average net assets. All voluntary and involuntary waivers should be disclosed on the face of the statement of operations as a reduction of total expenses. The expense ratio in the financial highlights should be shown net of voluntary and involuntary waivers. The effect of only voluntary waivers on the expense ratio should be disclosed (either as the basis point effect on the ratio or as the gross expense ratio) in a note to, or as part of, the financial highlights. In addition, the terms of all voluntary and involuntary waivers should be disclosed in the notes to the financial statements.

7.39 If a 12b-1 distribution reimbursement plan provides for the carryover of unreimbursed costs to subsequent periods, the terms of reimbursement and the unreimbursed amount should be disclosed. The auditor should be aware of the disclosure requirements in section 30(e)(5) of the 1940 Act, which deals with aggregate remuneration to directors or trustees and to each company of which any officer or director is an affiliated person. The auditor may conclude that the investment company has complied with the requirements by disclosure in the notes to the financial statements or in another manner that the investment company's management or legal counsel determines to be appropriate.

7.40 An investment company may have a brokerage service arrangement with a broker-dealer or an affiliate of a broker-dealer under which the broker-dealer (or its affiliate), in connection with the investment company's brokerage transactions directed to the broker-dealer, provides or pays for services to the investment company (other than brokerage and research services as those terms are used in section 28(e) of the Securities Exchange Act of 1934). The relevant expense caption on the statement of operations and the expense ratio in the financial highlights should include the amount that would have been incurred by the investment company for such services had it paid for the services directly in an arms-length transaction. Such amounts should also be shown as a corresponding reduction in total expenses, captioned as "Fees paid indirectly." For registered investment companies, the notes to the financial statements should include the total amounts by which expenses are increased, and should list each category that is increased by at least 5 percent of total expenses.[20]

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[20] Rule 6.07(g) of Regulation S-X.

7.41 Expense offset arrangements, under which a third party explicitly reduces its fees by a specified or readily ascertainable amount for services provided to the investment company in exchange for use of the investment company's assets, shall be presented in the statement of operations, the expense ratio in the financial highlights, and notes to the financial statements in the same manner as brokerage service arrangements.

7.42 Investment companies organized as limited partnerships typically receive advisory services from the general partner. Many partnerships pay fees for such services, others allocate net income from the limited partners' capital accounts to the general partner's capital account, and still others employ a combination of the two methods. The amounts of any such payments or allocations should be presented in either the statement of operations or the statement of changes in partners' capital in accordance with the partnership agreement, and the method of computing such payments or allocations should be described in the notes to the financial statements.

Net Investment Income

7.43 The excess of investment income over total expenses should be shown as net investment income (or loss). Any income tax provision relating to net investment income should be disclosed separately.

Net Realized Gain or Loss From Investments and Foreign Currency Transactions

7.44 *Net Realized Gain or Loss From Investments.* The statement of operations should disclose net realized gains or losses. Registered investment companies should make such disclosures by major kinds of investment transactions as required by rule 6.07.7 of Regulation S-X. Net realized gains or losses resulting from sales or other disposals should be reported net of brokerage commissions. An income tax provision charged against realized gains should be disclosed separately. Gains or losses arising from in-kind redemptions should be disclosed. The net realized gains or losses from investments and net realized gains or losses from foreign currency transactions may be reported separately or may be combined. Notes to the financial statements should state an entity's practice of either including or excluding that portion of realized and unrealized gains and losses from investments that result from foreign currency changes with or from other foreign currency gains and losses.

7.45 *Net Realized Gains or Losses From Foreign Currency Transactions.* Net gains or losses from assets or liabilities denominated in foreign currencies during the period should be reported separately. If separate reporting of foreign currency effects on realized gains or losses from investments is elected, those effects should be included in this caption. Guidance for computing such amounts appears in chapter 2.

7.46 The 1940 Act requires the disclosure of proceeds from sales and maturities of securities and the cost of securities purchased.[21] The SEC staff permits exclusion of short-term securities (those securities with a maturity of one year or less) from this disclosure. Information about common stocks, bonds, and preferred stocks may be combined or disclosed separately.

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[21] Section 30(e)(6) of the Investment Company Act of 1940.

Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Investments and Translation of Assets and Liabilities in Foreign Currencies

7.47 *Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Investments.* Changes in net unrealized appreciation or depreciation during the period should be reported in the statement of operations. The major components of unrealized appreciation or depreciation should be disclosed in a manner that is consistent with the guidance provided in paragraph 7.44. Either combining the net unrealized gains or losses from investments with net unrealized gains or losses from foreign currency transactions or reporting them separately is permissible. Any provision for deferred taxes should be reported separately.

7.48 *Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Translation of Assets and Liabilities in Foreign Currencies.* The net change during the period from translating assets and liabilities denominated in foreign currencies should be reported under this caption. Guidance for computing such amounts appears in chapter 2.

Net Increase From Payments by Affiliates and Net Gains (Losses) Realized on the Disposal of Investments in Violation of Restrictions

7.49 Affiliates may make payments to a fund related to investment losses for one of the following two reasons:

a. *Payments by Affiliates.* To reimburse the effect of a loss (realized or unrealized) on a portfolio investment, often caused by a situation outside the fund's, or its affiliates', direct control, such as an issuer default or a decline in fair value.

b. *Investment Restriction Violations (Investments Not Meeting Investment Guidelines).* Occasionally, a fund adviser may purchase an investment for a fund that clearly violates the fund's investment restrictions (investment restrictions are described in the prospectus or statement of additional information for registered funds and in partnership agreements or offering memorandums for nonregistered funds). The investment held in violation of the fund's investment restrictions may appreciate or depreciate in value. In the case where the investment has depreciated in value and the fund has consequently incurred a loss, the fund adviser may make a payment to the fund in lieu of settlement of a potential claim resulting from the violation of the fund's investment restrictions. This payment, in effect, makes the fund "whole" relative to the loss that it has incurred. This type of transaction is in essence a payment to put the fund's shareholders in the position they would have been in had the violation not occurred.

7.50 Payments made by affiliates for those two reasons should be combined and reported as a separate line item entitled "net increase from payments by affiliates and net gains (losses) realized on the disposal of investments in violation of restrictions" in the statement of operations as part of net realized and unrealized gains (losses) from investments and foreign currency. That separate line item would comprise amounts related to the following:

a. Voluntary reimbursements by the affiliate for investment transaction losses *b.* Realized and unrealized losses on investments not meeting the investment guidelines of the fund

c. Reimbursements from the affiliate for losses on investments not meeting the investment guidelines of the fund

d. Realized and unrealized gains on investments not meeting the investment guidelines of the fund

The amounts and circumstances of payments by affiliates to reimburse the fund for losses on investment transactions should be described in the notes to the financial statements. The gains and losses on investments not meeting investment guidelines of the fund should also be disclosed in the notes to the financial statements. In addition, the effect on total return[22] of the payments, as well as any gains or losses on investments not meeting investment guidelines of the fund, should be quantified and disclosed in the financial highlights in a manner similar to disclosure of the effect of voluntary waivers of fees and expenses on expense ratios.[23]

7.51 Payments by affiliates may take several forms, such as—

- A direct cash contribution to the fund to offset the effect of a realized loss on a portfolio investment.
- Purchase of securities from the fund at prices in excess of the securities' current fair value.
- Provision of a credit enhancement to maintain the investment's value.

With respect to the third item above, the payment should be recorded when the enhancement becomes available to the fund. The amount of the payment is measured by the cost of obtaining a similar enhancement in an arm's-length transaction. Any subsequent change in the value of the enhancement would be accounted for as unrealized appreciation or depreciation.

Net Realized and Unrealized Gain or Loss From Investments and Foreign Currency

7.52 The sum of the net realized gain or loss and change in unrealized gain or loss on investments and foreign-currency-denominated assets and liabilities should be presented in the statement of operations as a net gain or loss on investments and foreign currency.

Net Increase or Decrease in Net Assets From Operations

7.53 The sum of net investment income or loss and net realized and unrealized gain or loss on investments and foreign currency should be shown as a net increase or decrease in net assets resulting from operations.

Statement of Changes in Net Assets

7.54 The statement of changes in net assets summarizes results from operations, net equalization credits or debits, dividends and distributions to shareholders, capital share transactions, and capital contributions.

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[22] Total return is presented in the financial highlights.

[23] Disclosed in accordance with FASB Statement No. 57. Disclosure may be provided in a footnote to the financial highlights, such as the following: "In 20XX, a.aa% of the fund's total return consists of a voluntary reimbursement by the adviser for a realized investment loss, and another b.bb% consists of a gain on an investment not meeting the fund's investment restrictions. Excluding these items, total return would have been c.cc%. Additionally, the adviser fully reimbursed the fund for a loss on a transaction not meeting the fund's investment guidelines, which otherwise would have reduced total return by d.dd%.

7.55 The increase or decrease in net assets of a registered investment company comprises the following categories:

a. *Operations.* Net investment income or loss, net realized gains or losses from investments and foreign currency transactions, and changes in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies, as shown in the statement of operations, should be presented separately to arrive at the net change in net assets resulting from operations.

b. *Net equalization debits or credits.* If equalization accounting is used, undistributed investment income included in the price of capital shares issued or reacquired should be shown as a separate line item.

c. *Distributions to shareholders.* Distributions should be disclosed as a single line item, except for tax return of capital distributions, which should be disclosed separately. The tax-basis components of dividends paid (ordinary income distributions, long-term **capital gains distributions**, and return of capital distributions) should be disclosed in the notes.

Distributions made by regulated investment companies often differ from aggregate GAAP-basis undistributed net investment income (including net equalization credits or debits and undistributed net investment income) and accumulated net realized gains (total GAAP-basis net realized gains). The principal cause is that required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, rather than GAAP. The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. The primary reasons for any significant difference between total GAAP-basis net investment income and net realized gain and actual distributions should be disclosed in the notes to the financial statements. If in a subsequent period all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference should be reclassified to paid-in capital. Investment companies often distribute, after year end, a portion of undistributed investment income and security gains realized in the preceding year. If declared before the audit opinion date, per share amounts relating to those distributions are frequently disclosed in the notes to the financial statements.

d. *Capital share transactions.* The net change in net assets (excluding amounts shown separately if equalization accounting is used) arising from capital share transactions should be disclosed for each class of shares. The components of the change should be disclosed on the face of the statement or in the notes to the financial statements for each class of shares as follows:

(1) The number and value of shares sold

(2) The number and value of shares issued in reinvestment of distributions

(3) The number and cost of shares reacquired

(4) The net change

e. *Capital contributions.*

Net assets. Net assets at the beginning of the year and at the end of the year should be disclosed. The balance of net assets at the end of the year should agree with the comparable amount shown in the statement of assets and liabilities or in the statement of net assets.

7.56 For investment partnerships, the statement of changes in net assets may be combined with the statement of changes in partners' capital if the above information is presented.

Statement of Cash Flows

7.57 FASB Statement No. 95, *Statement of Cash Flows*, requires enterprises providing financial statements that report both financial position and results of operations to also provide a statement of cash flows for each period for which results of operations are provided. However, FASB Statement No. 102 exempts investment companies meeting certain conditions from the requirements of FASB Statement No. 95.

7.58 FASB Statement No. 102 exempts from the requirement to provide a statement of cash flows investment companies subject to the 1940 Act and investment enterprises that have essentially the same characteristics as those subject to the 1940 Act, provided that all of the following conditions are met:

a. During the period, substantially all of the enterprise's investments were highly liquid (for example, marketable securities and other assets for which a market is readily available).

b. Substantially all of the enterprise's investments are carried at fair value. (Securities for which fair value is determined using matrix pricing techniques would meet this condition. Other securities for which fair value is not readily determinable and for which fair value must be determined in good faith by the board of directors would not.)

c. The enterprise had little or no debt, based on average debt outstanding during the period in relation to average total assets. For this purpose, obligations resulting from redemptions of shares by the enterprise, from unsettled purchases of securities or similar assets, or from covered options written generally may be excluded from average debt outstanding. However, any extension of credit by the seller that is not in accordance with standard industry practice for redeeming shares or settling purchases of investments must be included in average debt outstanding.

d. The enterprise provides a statement of changes in net assets.

7.59 The statement explains the change during the period in cash and cash equivalents (including foreign currency). The statement classifies cash receipts and cash payments as resulting from operating, investing, and financing activities and includes a reconciliation of net cash provided by and used for operating activities to net increase or decrease in net assets from operating activities.

7.60 Should a statement of cash flows be required, the following information should be disclosed for a presentation using the direct method. (The indirect method is more commonly used. This method adjusts net increase or decrease in net assets from operations to arrive at net cash flows from operating activities.) Cash flows from operating activities should include the fund's investing activities. Cash flows from operating activities include—

a. Interest and dividends received.

b. Operating expenses paid.

c. Purchases of long-term investments (at cost).

d. Sales of long-term investments (proceeds).

e. Net sales or purchases of short-term investments.

f. Cash flows for other types of investing activities related to changes in margin accounts and collateral status, such as written options, financial futures contracts, securities lending, and so forth.

7.61 Cash flows from financing activities include—

a. Issuance and redemption of fund shares, including both common and preferred shares (excluding reinvestment of dividends and distributions).

b. Proceeds from and repayments of debt.

c. Dividends and distributions to shareholders (not including stock or reinvested dividends and distributions).

d. Bank overdrafts.

7.62 The reconciliation of net cash provided by or used for operating activities to net increase or decrease in net assets from operating activities includes the following:

a. Changes in noninvestment asset and liability accounts (such as interest receivable, accrued expenses, and other liabilities)

b. Noncash income and expense items (such as amortization of deferred charges, amortization of discount, and amortization of premium)

c. Realized and unrealized gains and losses on investment and foreign currency transactions

7.63 The effect of any foreign exchange fluctuations on cash balances should be disclosed as a separate line item.

7.64 Information about noncash investing and financing activities, such as reinvestments of dividends and distributions, should be disclosed.

Financial Highlights[24, *]

7.65 Financial highlights (see paragraph 7.01) should be presented either as a separate schedule or within the notes to the financial statements for each

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[24] See AICPA *Technical Practice Aids*, section 6910, *Investment Companies*, paragraphs .04 through .10, related to reporting financial highlights by private investment companies and paragraphs .11 through .15, related to reporting financial highlights by separate accounts.

[*] In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

Also in July 2003, AcSEC issued an exposure draft of another proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies, which provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

Final pronouncements are expected to be issued in the fourth quarter of 2003. The final SOPs would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOPs would be applied prospectively from the beginning of the year of adoption. Readers should be alert to final pronouncements.

class of common shares outstanding. Per share amounts presented are based on a share outstanding throughout each period presented. Investment companies with multiple classes of shares may present financial highlights only for those classes of shares that are included in reports to such shareholders. In such cases, the investment company should include appropriate disclosures related to all classes so as to ensure that the financial statements are complete (for example, detail of capital share activity in the statement of changes in net assets or notes to financial statements).

7.66 The following per share information should be presented for registered investment companies and for investment companies that compute unitized net asset value (a more detailed discussion of calculation methods for registered investment companies may be found in the instructions for preparation of registration statements on Forms N-1A and N-2):

a. Net asset value at the beginning of the period

b. Per share net investment income or loss, which, for registered investment companies, is calculated in accordance with the requirements of Form N-1A or N-2. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable. If used by a registered investment company, the method employed must be disclosed in a note to the table in conformity with SEC requirements.

c. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with the other per share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons should be disclosed.

d. Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss

e. Distributions to shareholders should be disclosed as a single line item except that tax return of capital distributions should be disclosed separately. Details of distributions should conform to those shown in the statement of changes in net assets.

f. Purchase premiums, redemption fees, or other capital items

g. Payments by affiliates (paragraphs 7.49 through 7.51)

h. Net asset value at the end of the period

i. Market value at the end of the period (Form N-2 registrants only)

7.67 Ratios of expenses and net investment income to average net assets are generally annualized for periods less than a year. The ratio of expenses to average net assets should be increased by brokerage service and expense offset arrangements (see paragraphs 7.40 and 7.41).

7.68 Total return is required to be presented for all investment companies (for interim periods, the disclosure should include whether or not total return is annualized), and should be computed as follows:

a. For nonregistered investment companies organized in a manner utilizing unitized net asset value and for N-1A registrants, based on the change in the net asset value per share during the period, and assuming that all dividends are reinvested.

b. For Form N-2 registrants, based on change in market value of the fund's shares taking into account dividends reinvested in accordance with the terms of the dividend reinvestment plan or, lacking such a plan, at the lesser of net asset value or market price on the dividend distribution date (Total investment return computed based on net asset value per share may also be presented if the difference in results between the two calculations is explained.)

c. For investment companies not utilizing unitized net asset value, including investment partnerships, based on the change in value during the period of a theoretical investment made at the beginning of the period

7.69 Additional information for investment companies filing on Forms N-1A and N-2 includes the following ratios and supplemental data:

a. Net assets, end of period

b. **Portfolio turnover rate**

c. If an investment company filing on Form N-2 has debt outstanding, the average amount of borrowings outstanding during the period, the weighted average number of the fund's shares outstanding during the period, and the average amount of debt per share during the period

7.70 The method of computing the portfolio turnover rate is described in the instructions to Forms N-SAR, N-1A, and N-2.

Other Disclosure Requirements

7.71 Pronouncements that usually affect disclosures by investment companies under GAAP include the following:

- FASB Statement No. 109, *Accounting for Income Taxes*, including—
  - The amounts and expiration dates of capital loss carryforwards and the amounts of any post-October capital and currency loss deferrals,[25] if significant.
  - Where applicable, the fact that the fund is not subject to income taxes. For registered investment companies, this is typically addressed by describing the company's status as a registered investment company under subchapter M of the Internal Revenue Code and also the principal assumptions on which the company relied in making or not making income tax provisions. Additionally, if the fund is not subject to income taxes, the net difference between the tax bases and the reported amounts of the fund's assets and liabilities should be disclosed.
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

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[25] RIC's may have realized net capital and foreign currency gains during the period from the beginning of their current taxable year through October 31, which they are required to distribute to avoid federal excise tax (see paragraph 6.03). If those RICs then incur net capital or currency losses from November 1 to the close of their taxable year, their Form 1120-RIC tax returns would indicate that they had made distributions during the taxable year in excess of taxable gains (that is, returns of capital), even though the distributions were properly paid from gains at the time of the "excise-tax" distribution. To avoid this result, federal income tax regulations permit such "post-October" losses to be deferred and recognized on the Form 1120-RIC tax return of the next succeeding taxable year.

- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement Nos. 137 and 138 and 149.*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*
- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

Interim Financial Statements

7.72 Rule 30d-1 of the 1940 Act requires that registered investment companies send semiannual reports to shareholders that should be complete, based on GAAP, and conform to the principles used in preparing annual financial statements. The statement of changes in net assets for registered investment companies should present information on the latest interim period (from preceding fiscal year end to end of interim period) and the preceding fiscal year. Financial highlights should be presented, at a minimum, for similar periods.

7.73 If management of a fund determines that a tax return of capital is likely to occur for the fund's fiscal year, although the exact amount may not be estimable, that fact should be disclosed in a note to the interim financial statements.

7.74 Unaudited interim financial data should be marked accordingly. Data summarized in condensed form should also be labeled. If the auditor is named or identified in interim reports on which he or she has performed no audit or review procedures, the auditor should insist that the reference be deleted or that a notation be included that the auditor does not express an opinion.[26]

7.75 In November 2002, the Auditing Standards Board (ASB) issued SAS No. 100, *Interim Financial Information*, which supersedes SAS No. 71 of the same name. SAS No. 100 provides additional guidance on performing reviews of interim financial information. The term *interim financial information* means financial information or statements covering a period less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end. SAS No. 100 is effective for interim periods within fiscal years beginning after December 15, 2002. Earlier application of the provisions of this Statement is permitted.

Illustrative Financial Statements of Management Investment Companies

7.76 The amounts in the accompanying financial statements, including the financial highlights, are illustrative[27]

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* On April 30, 2003, the FASB issued FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The Statement amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. This Statement is effective for contracts entered into or modified after June 30, 2003, with certain exceptions as described in FASB Statement No. 149, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. Readers should consider the requirements of FASB Statement No. 149 in addition to the guidance contained in FASB Statement No. 133, as amended, and this Guide.

[26] Statement on Auditing Standards (SAS) No. 26, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 504).

[27] The statement of net assets in the illustrative financial statements that follow presents investments in unaffiliated issuers that represent only 88 percent of total assets. An investment company registered with the SEC would be required to present a statement of assets and liabilities, including a separate schedule of investments, rather than a statement of net assets.

ships among accounts. The financial statements illustrate the presentation of various items, if material. In addition, in some circumstances, information presented in the notes to the financial statements may be better presented within the financial statements.

7.77 To comply with SEC rules and regulations, registered investment companies must make certain disclosures in addition to those required by GAAP. Those additional requirements are presented in the illustrative financial statements, although they are not otherwise required by GAAP. SEC rules and regulations may require certain information included in the illustration to be displayed on the face of certain statements, such as components of net assets. From time to time, the SEC may administratively require additional disclosures in the financial statements. At the time of this Guide's publication, SEC compliance disclosures that are not required under GAAP include, but are not limited to, the following:

- A requirement to present a statement of assets and liabilities instead of a statement of net assets if the amount of investments in securities of unaffiliated issuers represents less than 95 percent of total assets
- Additional disclosures required by rule 12-12 (note 2) of Regulation S-X pertaining to collateral for repurchase agreements, and by rule 4-08(m) of Regulation S-X requiring certain additional disclosures if the carrying amounts of repurchase or reverse repurchase agreements exceed 10 percent of total assets or the amount at risk (as defined) under such agreements exceeds 10 percent of net asset value
- Additional disclosures about restricted securities (acquisition date, unit carrying value, and cost, among others) in accordance with the SEC's *Codification of Financial Reporting Policies*, section 404, and rule 12-12 (note 6) of Regulation S-X
- Details with respect to written options activity as required by rule 6-07.7(c) of Regulation S-X
- Gross unrealized appreciation and depreciation as well as net unrealized appreciation or depreciation, all on a tax basis, in accordance with rule 12-12 (note 8) of Regulation S-X
- Disclosure of non-income producing securities as required by rule 12-12 (note 5) of Regulation S-X
- Additional disclosures required by rules 6.04.2(b), 6.07.1, and 6.07.7 pertaining to investments in and income from affiliates as defined by section 2 of the 1940 Act to include any investment in which more than 5 percent of the outstanding voting securities is owned by the fund

Disclosures included in the illustrative financial statements presented in the remainder of this chapter are not intended to be comprehensive and are not intended to establish preferences among alternative disclosures. The illustrative financial statements presented are those of a registered investment company and therefore include certain, but not all, disclosures required by SEC regulation in addition to requirements under GAAP.

7.78

XYZ Management Investment Company
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investments in securities, at fair value (cost $19,292,000)—including $570,000 of securities loaned (Note 8)[28]	$21,721,000
Cash denominated in foreign currencies (cost $141,000)	139,000
Cash	60,000
Deposits with brokers for securities sold short	1,555,000
Receivables	
Dividends and interest	46,000
Investment securities sold	24,000
Capital stock sold	54,000
Unrealized gain on foreign currency exchange contract (Note 8)	419,000
Other assets	26,000
Total assets	24,044,000
Liabilities	
Call options written, at fair value (premiums received $110,000)	230,000
Securities sold short, at fair value (proceeds $1,555,000)	1,673,000
Demand loan payable to bank (Note 5)	2,000,000
Payable upon return of securities loaned (Note 8)	620,000
Unrealized loss on foreign currency exchange contract (Note 8)	108,000
Due to broker—variation margin	10,000
Payables	
Investment securities purchased	52,000
Capital stock reacquired	8,000
Other	4,000
Accrued expenses	8,000
Distribution payable	158,000
Total liabilities	4,871,000
Net assets	$19,173,000
Analysis of Net Assets:	
Net capital paid in on shares of capital stock	$15,184,000
Distributable earnings	3,989,000
Net assets (equivalent to $4.55 per share based on 4,216,000 shares of capital stock outstanding) (Note 6)	$19,173,000

The accompanying notes are an integral part of these financial statements.

[28] Investments in securities include securities purchased with cash proceeds from securities loans. When cash is received as collateral in secured borrowings, the cash received should be recognized as the investment company's asset along with the obligation to return the cash. If the investment company makes investments with the cash, even if made by agents or in pools with other securities lenders, the investment company should reflect the investments as part of its holdings in the schedule of investments and should footnote any restrictions associated with the investment because of the collateral arrangements.

With regard to collateral received in the form of securities in secured borrowings, if the securities received may be sold or repledged, the investment company should account for those securities in the same way as it would account for cash received. That is, the investment company should record the securities received as the investment company's asset along with the obligation to return the securities. However, if the investment company does not have the right to sell or repledge the securities received as collateral, then the investment company should not record the securities or the related liability on its books.

7.79

XYZ Management Investment Company
Schedule (or Portfolio) of Investments in Securities
December 31, 20X4

[Note: Securities may be arranged by industry groupings or other groupings (showing percentage of total portfolio or of net assets invested in each grouping) that the Company believes are most meaningful to users. The basis of the computation of percentages shown (which in this illustration is the ratio of the specific category of securities to the total portfolio owned) should be disclosed.]

	Principal Amount or Shares	*Fair Value*
Common stocks—29%		
Consumer durable goods—5%		
Allied Manufacturing Corporation*	25,000	$ 620,000
Baker Industries, Inc.**	15,000	150,000
Consumer Goods Company*	8,000	300,000
Other		16,000
		1,086,000
Consumer nondurable goods—16%		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	3,280,000
American Company	4,000	100,000
Other		55,000
		3,435,000
Service industries—4%		
Service Company, Inc.	10,000	465,000
Cannon Sales	13,000	400,000
Other		4,000
		869,000
Other industry groupings—4%		921,000
[Additional industry groupings and details of the fifty largest holdings are not included in this illustration]		
Total common stocks		6,311,000
Convertible bonds—25%		
American Retailing Inc.—5.5% debenture due 20XX	$ 500,000	525,000
Paper Airplane Corporation—6.25% debenture due 20XX	4,500,000	4,875,000
Total convertible securities		5,400,000
Indexed securities—10%		
American Trust Co. (principal linked to deutsche mark yield curve)—10% due 20XX	2,000,000	2,100,000

(continued)

	Principal Amount or Shares	Fair Value
Mortgage-backed securities—12%		
FNMA 8% due 20XX	$2,000,000	$ 1,950,000
FNMA strip, principal only, zero coupon, due 20XX	1,000,000	760,000
Total mortgage-backed securities		2,710,000
U.S. government obligations—16%		
U.S. Treasury 6% notes due 20XX	500,000	490,000
U.S. Treasury 8% notes due 20XX	3,000,000	2,985,000
Total U.S. government obligations		3,475,000
Short-term notes—6%		
Commercial Paper, Inc., 5.5% due 2/5/X5	505,000	506,000
U.S. Treasury bills, 5.2% due 1/20/X5***	725,000	719,000
Total short-term notes		1,225,000
Repurchase agreements—2%		
Money Center Bank of Large City, 4%, dated 12/29/X4, due 1/3/X5, repurchase price $500,274, collateralized by U.S. Treasury bonds	500,000	500,000
Total—100% (cost $19,292,000)		$21,721,000

Note—Aggregate value of segregated securities—$372,000.

The accompanying notes are an integral part of these financial statements.

* Portion of the security is pledged as collateral for call options written.

** Non-income producing security.

*** Portion of the security is purchased with the cash proceeds from securities loans. (The investment company should also footnote any restrictions associated with the investment because of the collateral arrangements.)

7.80

XYZ Management Investment Company
Call Options Written
December 31, 20X4

Common Stocks / Expiration Date / Exercise Price	*Shares Subject to Call*	*Fair Value*
Allied Manufacturing Corporation/July/25	10,000	$ 50,000
Allied Manufacturing Corporation/October/30	5,000	2,500
Consumer Goods Company September/45	7,000	177,500
Total (premiums received $110,000) (Note 3)		$230,000

The accompanying notes are an integral part of these financial statements.

7.81

XYZ Management Investment Company
Securities Sold Short
December 31, 20X4

Common Stocks	*Shares*	*Fair Value*
International Widgets, Inc.	40,000	$ 425,000
Paper Airplane Corporation	25,000	265,000
Amber Company	100,000	983,000
Total (proceeds $1,555,000)		$1,673,000

The accompanying notes are an integral part of these financial statements.

7.82

XYZ Management Investment Company
Statement of Net Assets
December 31, 20X4

[*Note: Securities may be arranged by industry or other groupings (showing percentage of total portfolio or of net assets invested in each grouping) that the Company believes will be most meaningful to users.*]

	Shares or Principal Amount	*Fair Value*
Assets		
Investment in securities—113% of net assets		
Common stocks—33%		
Consumer durable goods—6%		
Allied Manufacturing Corporation*	25,000	$ 620,000
Baker Industries, Inc.**	15,000	150,000
Consumer Goods Company*	8,000	300,000
Other	600	16,000
		1,086,000
Consumer nondurable goods—18%		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	3,280,000
American Company	4,000	100,000
Other	2,000	55,000
		3,435,000
Service industries—4%		
Service Company, Inc.	10,000	465,000
Cannon Sales	13,000	400,000
Other	200	4,000
		869,000
Other industry groupings—5%		921,000
[*Additional industry groupings and details of the fifty largest holdings are not included in this illustration.*]		
Total common stocks		6,311,000
Convertible bonds—28%		
American Retailing Inc.—5.5% debenture due 20XX	$ 500,000	525,000
Paper Airplane Corporation—6.25% debenture due 20XX	4,500,000	4,875,000
Total convertible bonds		5,400,000
Indexed securities—11%		
American Trust Co. (principal linked to deutsche mark yield curve)—10% due 20XX	2,000,000	2,100,000

(continued)

	Shares or Principal Amount	Fair Value
Mortgage-backed securities—14%		
FNMA, 8% due 20XX	$2,000,000	$1,950,000
FNMA strip, principal only, zero coupon, due 20XX	1,000,000	760,000
Total mortgage-backed securities		2,710,000
U.S. government obligations—18%		
U.S. Treasury 6% notes due 20XX	500,000	490,000
U.S. Treasury 8% notes due 20XX	3,000,000	2,985,000
Total U.S. government obligations		3,475,000
Short-term notes—6%		
Commercial Paper, Inc., 5.5% due 2/5/X5	505,000	506,000
U.S. Treasury bills, 5.2% due 1/20/X5***	725,000	719,000
Total short-term notes		1,225,000
Repurchase agreements—3%		
Money Center Bank of Large City, 4%, dated 12/29/X4 due 1/3/X5, repurchase price $500,274, collateralized by U.S. Treasury bonds	500,000	500,000
Total investments in securities (cost $19,292,000)—including $570,000 of securities loaned (Note 8)[29]		21,721,000
Cash denominated in foreign currencies (cost $141,000)		139,000
Cash		60,000
Deposits with brokers for securities sold short		1,555,000
Receivables		
Dividends and interest		46,000
Investment securities sold		24,000
Capital stock sold		54,000
Unrealized gain on foreign currency exchange contract (Note 8)		419,000
Other assets		26,000
Total assets		24,044,000

(continued)

[29] Investments in securities include securities purchased with cash proceeds from securities loans. When cash is received as collateral in secured borrowings, the cash received should be recognized as the investment company's asset along with the obligation to return the cash. If the investment company makes investments with the cash, even if made by agents or in pools with other securities lenders, the investment company should reflect the investments as part of its holdings in the schedule of investments and should footnote any restrictions associated with the investment because of the collateral arrangements.

With regard to collateral received in the form of securities in secured borrowings, if the securities received may be sold or repledged, the investment company should account for those securities in the same way as it would account for cash received. That is, the investment company should record the securities received as the investment company's asset along with the obligation to return the securities. However, if the investment company does not have the right to sell or repledge the securities received as collateral, then the investment company should not record the securities or the related liability on its books.

	Shares or Principal Amount	Fair Value
Liabilities		
Call options written, at fair value (premiums received $110,000)		230,000
Securities sold short, at fair value (proceeds $1,555,000)		1,673,000
Demand loan payable to bank (Note 5)		2,000,000
Payable upon return of securities loaned (Note 8)		620,000
Unrealized loss on foreign currency exchange contract (Note 8)		108,000
Due to broker—variation margin		10,000
Payables		
Investment securities purchased		$ 52,000
Capital stock reacquired		8,000
Other		4,000
Accrued expenses		8,000
Distribution payable		158,000
Total liabilities		4,871,000
Net assets		$19,173,000
Analysis of Net Assets:		
Net capital paid in on shares of capital stock		$15,184,000
Distributable earnings		3,989,000
Net assets (equivalent to $4.55 per share based on 4,216,000 shares of capital stock outstanding) (Note 6)		$19,173,000

Note—Aggregate value of segregated securities—$372,000.

The accompanying notes are an integral part of these financial statements.

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* Portion of the security is pledged as collateral for call options written.

** Non-income producing security.

*** Portion of the security is purchased with the cash proceeds from securities loans. (The investment company should also footnote any restrictions associated with the investment because of the collateral arrangements.)

7.83

XYZ Management Investment Company
Statement of Operations
Year Ended December 31, 20X4

Investment income		
Dividends (net of foreign withholding taxes of $20,000)	$ 742,000	
Interest	209,000	
Income from securities loaned–net	50,000	
Total income		$ 1,001,000
Expenses		
Investment advisory fee	135,000	
Interest	55,000	
Professional fees (Note 9)	29,000	
Custodian and transfer agent fees	16,000	
Distribution expenses (Note 9)	4,000	
State and local taxes other than income taxes	15,000	
Directors' fees	12,000	
Dividends on securities sold short	9,000	
Total expenses		275,000
Fees paid indirectly (Note 9)		(4,000)
Fees waived (Note 9)		(45,000)
Net expenses		226,000
Net investment income		775,000
Realized and unrealized gain (loss) from investments and foreign currency:		
Net realized gain (loss) from—		
Investments		1,089,000
Foreign currency transactions*		(44,000)
		1,045,000
Net increase (decrease) in unrealized appreciation (depreciation) on—		
Investments		(1,647,000)
Translation of assets and liabilities in foreign currencies*		353,000
		(1,294,000)
Net realized and unrealized loss from investments and foreign currency		(249,000)
Net increase in net assets resulting from operations		$ 526,000

The accompanying notes are an integral part of these financial statements.

* If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

7.84

XYZ Management Investment Company
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	20X3
Increase (decrease) in net assets from operations		
Investment income—net	$ 775,000	$ 492,000
Net realized gain from investments and foreign currency*	1,045,000	1,000,000
Unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies**	(1,294,000)	1,551,000
Net increase in net assets resulting from operations	526,000	3,043,000
Distributions to shareholders	(1,875,000)	(1,350,000)
Tax return of capital to shareholders	—	(66,000)
Capital share transactions (Note 6)	2,730,000	1,755,000
Total increase	1,381,000	3,382,000
Net assets		
Beginning of year	17,792,000	14,410,000
End of year	$19,173,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

* It is also acceptable to present each of these items as a separate line item: net realized gains from investments; net realized gains (losses) from foreign currency transactions.

** It is also acceptable to present each of these items as a separate line item: unrealized appreciation of investments; unrealized appreciation on translation of assets and liabilities in foreign currencies.

7.85

XYZ Management Investment Company
Statement of Cash Flows
Year Ended December 31, 20X4

Increase (decrease) in cash—	
Cash flows from operating activities:	
Net increase in net assets from operations	$ 526,000
Adjustments to reconcile net increase in net assets from operations to net cash used in operating activities:	
Purchase of investment securities	(26,720,000)
Proceeds from disposition of investment securities	26,030,000
Sale of short-term investment securities, net	(921,000)
Increase in deposits with brokers for short sales	(555,000)
Increase in collateral for securities loaned	(270,000)
Increase in dividends and interest receivable	(18,000)
Decrease in receivables for securities sold	306,000
Increase in equity on foreign currency contracts	(363,000)
Increase in other assets	(2,000)
Increase in call options written	50,000
Increase in securities sold short	823,000
Increase in payable upon return of securities loaned	270,000
Decrease in variation margin payable	(4,000)
Decrease in payable for securities purchased	(77,000)
Increase in accrued expenses	1,000
Unrealized appreciation on securities and currencies	1,647,000
Net realized gain from investments and currencies	(1,089,000)
Net cash used in operating activities	(366,000)
Cash flows from financing activities:	
Decrease in loan payable	(400,000)
Proceeds from shares sold	2,143,000
Payment on shares redeemed	(450,000)
Cash distributions paid	(841,000)
Net cash provided by financing activities	452,000
Net increase in cash	86,000
Cash:	
Beginning balance	113,000
Ending balance	$ 199,000

Supplemental disclosure of cash flow information:

Noncash financing activities not included herein consist of reinvestment of dividends and distributions of $1,000,000.

The accompanying notes are an integral part of these financial statements.

7.86

XYZ Management Investment Company
Notes to Financial Statements

1. Significant Accounting Policies

XYZ Management Company (the Company) is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The investment objective of the Company is to seek a high total return consisting of both current income and realized and unrealized gains from equity and debt securities.

Security valuation. Investments in securities traded on a national securities exchange (or reported on the NASDAQ national market) are stated at the last reported sales price on the day of valuation; other securities traded in the over-the-counter market and listed securities for which no sale was reported on that date are stated at the last quoted bid price, except for short positions and call options written, for which the last quoted asked price is used. Short-term notes are stated at amortized cost, which approximates fair value. Restricted securities and other securities for which quotations are not readily available are valued at fair value as determined by the board of directors. The ability of issuers of debt securities held by the Company to meet their obligations may be affected by economic and political developments in a specific country or region.

Repurchase agreements. In connection with transactions in repurchase agreements, it is the Company's policy that its custodian take possession of the underlying collateral securities, the fair value of which exceeds the principal amount of the repurchase transaction, including accrued interest, at all times. If the seller defaults, and the fair value of the collateral declines, realization of the collateral by the Company may be delayed or limited.

Foreign currency. Investment securities and other assets and liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the date of valuation. Purchases and sales of investment securities and income and expense items denominated in foreign currencies are translated into U.S. dollar amounts on the respective dates of such transactions.

The Company does not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held. Such fluctuations are included with the net realized and unrealized gain or loss from investments.

Reported net realized foreign exchange gains or losses arise from sales of foreign currencies, currency gains or losses realized between the trade and settlement dates on securities transactions, and the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the fund's books and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the fair values of assets and liabilities, other than investments in securities at fiscal period end, resulting from changes in exchange rates.

[*The following paragraphs illustrate disclosures for a fund that chooses to report the foreign currency elements of realized and unrealized gains and losses on investments.*]

The Company isolates that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held.

Reported net realized foreign exchange gains or losses arise from sales of portfolio securities, sales and maturities of short-term securities, sales of foreign currencies, currency gains or losses realized between the trade and settlement dates on securities transactions, and the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the Company's books and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the values of assets and liabilities, including investments in securities at fiscal period end, resulting from changes in the exchange rate.

Option writing. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company on the expiration date as realized gains from investments. The difference between the premium and the amount paid on effecting a closing purchase transaction, including brokerage commissions, is also treated as a realized gain, or, if the premium is less than the amount paid for the closing purchase transaction, as a realized loss. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. If a put option is exercised, the premium reduces the cost basis of the securities purchased by the Company. The Company as writer of an option bears the market risk of an unfavorable change in the price of the security underlying the written option.

Security loans. The Company receives compensation in the form of fees, or it retains a portion of interest on the investment of any cash received as collateral. The Company also continues to receive interest or dividends on the securities loaned. The loans are secured by collateral at least equal, at all times, to the fair value of the securities loaned plus accrued interest. Gain or loss in the fair value of the securities loaned that may occur during the term of the loan will be for the account of the Company. The Company has the right under the lending agreement to recover the securities from the borrower on demand.

Financial futures contracts. The Company invests in financial futures contracts solely for the purpose of hedging its existing portfolio securities, or securities that the Company intends to purchase, against fluctuations in fair value caused by changes in prevailing market interest rates. Upon entering into a financial futures contract, the Company is required to pledge to the broker an amount of cash, U.S. government securities, or other assets, equal to a certain percentage of the contract amount (initial margin deposit). Subsequent payments, known as "variation margin," are made or received by the Company each day, depending on the daily fluctuations in the fair value of the underlying security. The Company recognizes a gain or loss equal to the daily variation margin. Should market conditions move unexpectedly, the Company may not achieve the anticipated benefits of the financial futures contracts and may realize a loss. The use of futures transactions involves the risk of imperfect correlation in movements in the price of futures contracts, interest rates, and the underlying hedged assets.

Short sales. The Company may sell a security it does not own in anticipation of a decline in the fair value of that security. When the Company sells a security short, it must borrow the security sold short and deliver it to the broker-dealer through which it made the short sale. A gain, limited to the price at which the Company sold the security short, or a loss, unlimited in size, will be recognized upon the termination of a short sale.

Foreign currency contracts. The Company may enter into forward foreign currency exchange contracts primarily to hedge against foreign currency exchange rate risks on its non-U.S. dollar denominated investment securities. When entering into a forward currency contract, the Company agrees to receive or deliver a fixed quantity of foreign currency for an agreed-upon price on an agreed future date. These contracts are valued daily, and the Company's net equity therein, representing unrealized gain or loss on the contracts as measured by the difference between the forward foreign exchange rates at the dates of entry into the contracts and the forward rates at the reporting date, is included in the statement of assets and liabilities. Realized and unrealized gains and losses are included in the statement of operations. These instruments involve market risk, credit risk, or both kinds of risks, in excess of the amount recognized in the statement of assets and liabilities. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movement in currency and securities values and interest rates.

Federal income taxes. The Company's policy is to continue to comply with the requirements of the Internal Revenue Code that are applicable to regulated investment companies and to distribute all its taxable income to its shareholders. Therefore, no federal income tax provision is required.

Distributions to shareholders. Distributions to shareholders, which are determined in accordance with income tax regulations, are recorded on the ex-dividend date.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of increases and decreases in net assets from operations during the reporting period. Actual results could differ from those estimates.

Other. The Company records security transactions based on a trade date. Dividend income is recognized on the ex-dividend date, and interest income is recognized on an accrual basis. Discounts and premiums on securities purchased are amortized, over the lives of the respective securities. Withholding taxes on foreign dividends have been provided for in accordance with the Company's understanding of the applicable country's tax rules and rates.

2. Restricted Securities

The investment in 10,000 shares of Amalgamated Buggy Whips, Inc. common stock, the sale of which is restricted, has been valued by the board of directors at $328 per share after considering certain pertinent factors, including the results of operations of Amalgamated since the date of purchase on March 15, 20X1, for $1,580,000 and the sales price of recent private placements in its common stock. No quoted market price exists for Amalgamated shares.[30] It is possible that the estimated value may differ significantly from the amount that might ultimately be realized in the near term, and the difference could be material.

3. *Call Options Written*[*]

As of December 31, 20X4, portfolio securities valued at $372,000 were held in escrow by the custodian as cover for call options written by the Company.

Transactions in options written during the year ended December 31, 20X4, were as follows:

	Number of Contracts	*Premiums Received*
Options outstanding at December 31, 20X3	100	$ 100,000
Options written	500	500,000
Options terminated in closing purchase transactions	(150)	(190,000)
Options expired	(80)	(150,000)
Options exercised	(150)	(150,000)
Options outstanding at December 31, 20X4	220	$ 110,000

4. *Distributions to Shareholders*

On January 3, 20X5, a distribution of $0.20 per share was declared. The dividend was paid on January 20, 20X5, to shareholders of record on January 10, 20X5.

The tax character of distributions paid during 20X4 and 20X3 was as follows:

	20X4	*20X3*
Distributions paid from:		
Ordinary income	$ 755,000	$ 550,000
Long-term capital gain	1,120,000	800,000
	1,875,000	1,350,000
Return of capital	—	66,000
	$1,875,000	$1,416,000

As of December 31, 20X4, the components of distributable earnings on a tax basis were as follows:

Undistributed ordinary income	$1,304,000
Undistributed long-term gain	1,145,000
Unrealized appreciation	1,540,000
	$3,989,000

[30] If several **restricted security** investments are held, a general statement on the valuation methods may be given rather than individual description, as well as the aggregate value of such securities.

[*] Practitioners should consider all of the disclosure requirements of FASB Statement No. 133 and related amendments which may not be necessarily reflected in these financial statements and notes to the financial statements.

The difference between book basis and tax-basis unrealized appreciation is attributable primarily to the tax deferral of losses on wash sales and the realization for tax purposes of unrealized gains on certain forward foreign currency contracts and on investments in passive foreign investment companies.

5. Bank Loans

The Company has an unsecured $3,000,000 bank line of credit; borrowings under this arrangement bear interest at 110 percent of the bank's prime rate. As of December 31, 20X4, the Company was paying interest at 8 percent per year on its outstanding borrowings. No compensating balances are required.

6. Capital Share Transactions

As of December 31, 20X4, 25,000,000 shares of $0.50 par value capital stock were authorized.

Transactions in capital stock were as follows:

	Shares		*Amount*	
	20X4	*20X3*	*20X4*	*20X3*
Shares sold	452,000	329,000	$2,186,000	$1,440,000
Shares issued in reinvestment of distributions	222,000	207,000	1,000,000	845,000
	674,000	536,000	3,186,000	2,285,000
Shares redeemed	104,000	121,000	456,000	530,000
Net increase	570,000	415,000	$2,730,000	$1,755,000

7. Investment Transactions

Purchases and sales of investment securities (excluding short-term securities and U.S. government obligations) were $23,420,000 and $24,030,000, respectively.

The U.S. federal income tax basis of the Company's investments at December 31, 20X4, was $19,321,000, and net unrealized appreciation for U.S. federal income tax purposes was $1,780,000 (gross unrealized appreciation $2,380,000; gross unrealized depreciation $600,000).

8. Portfolio Securities Loaned, Financial Futures Contracts, and Forward Currency Contracts*

As of December 31, 20X4, the Company loaned common stocks having a fair value of approximately $570,000, and received $620,000 of cash collateral for the loan. This cash was invested in U.S. Treasury bills with maturities ranging from January to April 20X5.

As of December 31, 20X4, the Company sold ten financial futures contracts on ten-year U.S. Treasury notes for delivery in March 20X5. The Company has recorded a realized loss of $50,000 as of December 31, 20X4.

* Practitioners should consider all of the disclosure requirements of FASB Statement No. 133 and related amendments which may not be necessarily reflected in these financial statements and notes to the financial statements.

At December 31, 20X4, the Company sold the following foreign currency exchange contracts:

	Unrealized Gain	*Unrealized Loss*
1,407,900,000 Japanese yen vs. $14,588,000 for settlement January 25, 20X5	$419,000	
14,394,000 Euro vs. $13,206,000 for settlement March 7, 20X5	—	$(108,000)
	$419,000	$(108,000)

9. Investment Advisory Fees and Other Transactions With Affiliates

The Company receives investment management and advisory services under a management agreement (Agreement) that provides for fees to be paid at an annual rate of 0.65 percent of the Company's average daily net assets. Certain officers and directors of the Company are also officers and directors of the investment adviser. The Agreement provides for an expense reimbursement from the investment adviser if the Company's total expenses, exclusive of taxes, interest on borrowings, dividends on securities sold short, brokerage commissions, and extraordinary expenses, exceed 1.5 percent of the Company's average daily net assets for any full fiscal year. During the year ended December 31, 20X4, the investment adviser voluntarily waived $45,000 of its fee.

The investment adviser also received $5,000 in 20X4 from brokerage fees on executions of purchases and sales of the Company's portfolio investments.

During 20X4, the Company incurred legal fees of $7,000 to Brown and Smith, counsel for the Company. A partner of the firm is a director of the Company.

MNO Service Company (MNO), an affiliate of the investment adviser, is the distributor of the Company's shares, and received $10,000 in 20X4 from commissions earned on sales of the Company's capital stock. The Company has entered into a distribution agreement and plan of distribution pursuant to which the Company pays MNO a fee, accrued daily and payable monthly, at an annual rate of 0.75 percent of average daily net assets of the Company. During the year ended December 31, 20X4, MNO received contingent deferred sales charges of $18,000 from redeeming shareholders. Also, the amount of distribution expenses incurred by MNO and not yet reimbursed was approximately $187,000. This amount may be recovered from future payments under the plan or contingent deferred sales charges.

Included in the statement of operations under the caption "custodian and transfer agent fees" are expense offsets of $4,000 arising from credits on cash balances maintained on deposit.

7.87

Financial Highlights

	20X4	*20X3*	*20X2*	*20X1*	*20X0**
Per Share Operating Performance (For a share of capital stock outstanding throughout the period):					
Net asset value, beginning of period	$ 4.88	$ 4.46	$ 4.16	$ 4.81	$ 4.53
Income from investment operations:					
Net investment income	0.21	0.15	0.19	0.17	0.15
Net realized and unrealized gain (loss) on investment transactions	(0.04)	0.76	0.52	(0.42)	0.48
Total from investment operations	0.17	0.91	0.71	(0.25)	0.63
Less distributions	(0.50)	(0.47)	(0.41)	(0.40)	(0.35)
Tax return of capital distribution	—	(0.02)	—	—	—
Total distributions	(0.50)	(0.49)	(0.41)	(0.40)	(0.35)
Net asset value, end of period	$ 4.55	$ 4.88	$ 4.46	$ 4.16	$ 4.81
Total Return:**	3.48%	20.40%	17.07%	(5.02)%	3.91%
Supplemental Data:					
Net assets, end of period (000)	$19,173	$17,792	$14,410	$15,000	$14,000
Ratio to average net assets:					
Expenses***	1.33%†	1.31%	.99%	.82%	.84%†
Net investment income***	4.56%†	2.82%	4.22%	5.42%	5.10%†
Portfolio turnover rate	92%	80%	108%	75%	62%

The accompanying notes are an integral part of these financial statements.

* Period from March 1, 20X0 (inception) to December 31, 20X0.

** Not annualized for periods less than a year.

*** Annualized for periods less than one year.

† Such percentages are after advisory fee waivers and expense subsidies. The adviser voluntarily waived a portion of its investment advisory fee (equal to 0.22% of average net assets) in 20X4 and subsidized certain operating expenses (equal to 0.21% of average net assets) in 20X0.

Chapter 8
Other Accounts and Considerations

Investment Advisory (Management) Fee

8.01 As discussed in chapter 1, an investment company usually engages an investment adviser for a fee, which is the largest expense incurred by the investment company. This fee is usually reflected in the daily net asset value calculation at rates established by the investment advisory agreement. Certain agreements may provide for performance fee adjustments based on a comparison of the investment company's performance against an index specified in the agreement.

8.02 Performance fees should be accrued at interim dates based on actual performance through the accrual date. However, according to the Securities and Exchange Commission's (SEC) policy, interim payments to the adviser should be based on the minimum fee provided in the agreement, because if performance for the year yields a fee that is lower than the interim payments, the excess may represent a loan to the adviser. Performance fees based on a rolling or moving period are discussed in Release No. 7113 of the Investment Company Act of 1940 (the 1940 Act).

Expenses

8.03 The investment company's expenses should be reviewed for compliance with the provisions of the investment advisory contract, the prospectus, and other relevant agreements. The investment company estimates its other expenses for the year, and for the period within which it will incur them, and allocates them, usually daily, in computing net asset value. Estimated annual expenses should be reviewed continually and accruals adjusted as required. Typically, asset-based fees are recalculated by the auditor for reasonableness, and other expense items are reviewed by analytical procedures.

8.04 Some investment company prospectuses, offering memoranda, or agreements between the adviser or other servicer (such as an administrator) and the fund may require the servicer to waive its fee and reimburse or assume certain expenses that exceed stated limitations. The auditor should review the calculations for agreement with the governing document.

8.05 Some **expense limitation** agreements may provide that reimbursements by the fund adviser of expenses incurred by the fund in excess of the maximum permitted by the prospectus or offering document will be carried over to a future period and reimbursed to the fund adviser when, and to the extent that, the total expense ratio falls below the permitted maximum. Such agreements may also provide that reimbursement of excess expenses to the fund adviser is not required after a specified date or upon conclusion of a specified period from the time the fund initially incurred, or the adviser initially reimbursed, the expenses, such as three years. A liability for such excess expenses should be recorded if, and to the extent that, the established terms for repayment of the excess expenses to the adviser by the fund and the attendant circumstances meet criteria (a), (b), and (c) of Financial Accounting

Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 36 and the criteria of FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, paragraph 8. In most instances, a liability will not be recorded because it is not likely that excess expenses under such plans will meet the criteria in those paragraphs before amounts are actually due to the adviser under the reimbursement agreement. Under most excess expense plans, a fund is obligated to repay a servicer for expenses incurred previously only if, during a defined period, the fund (*a*) retains the service provider and (*b*) can reduce its expense ratio to a low enough level to permit payment, and maintain that ratio at a sufficiently low level thereafter. Many substantive conditions could cause the fund to have no obligation to the servicer, including failure to attract assets, significant redemptions of shares by investors, market depreciation, and significant increases in other expenses, all of which could drive expenses up to or beyond the maximum under which payment would otherwise be made. The existence of reimbursement agreements and, if material, the carryover of excess expenses potentially reimbursable to the adviser but not recorded as a liability should be disclosed in the notes to the financial statements. If an assessment of the specific circumstances (such as an agreement to reimburse for either an unlimited period or a period substantially greater than that necessary for the fund to demonstrate its economic viability or an obligation to reimburse the servicer remains even after the cancellation of the fund's contract with the servicer) indicates that the criteria identified above are met, a liability should be recorded.

Distribution Expenses

8.06 Open-end investment companies are permitted to finance the distribution of their shares under a plan pursuant to rule 12b-1 of the 1940 Act ("12b-1 plan"). Under rule 12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it. These plans exist in many forms, and the auditor should review the plan provisions. Distribution expenses paid with an investment company's assets are accounted for as operating expenses. Under a **traditional 12b-1 plan**, a fund's distributor may be compensated or reimbursed for its distribution efforts or costs through one or more of the following methods:

- A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a **compensation plan**) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting contingent deferred sales loads (CDSLs) received by the distributor (a **reimbursement plan**). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.
- A front-end load, which is assessed on purchasing shareholders at the time the fund shares are sold.
- A CDSL imposed directly on redeeming shareholders. The CDSL usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The CDSL normally ranges from 4 percent to 6 percent and typically is reduced by 1 percent a year (for example, from 6 percent to 5 percent) until the sales charge reaches zero percent.

8.07 Rules established by the National Association of Securities Dealers (NASD) construe 12b-1 fees to be either "asset based sales charges" or "service fees." These rules (section 26 of the NASD Rules of Fair Practice) limit the amount of asset-based sales charges that may be charged in any year to specified percentages of average net assets and provide aggregate limitations on the total amounts of sales charges received through front-end sales loads, deferred sales charges, and asset-based sales charges. If a 12b-1 distribution reimbursement plan provides for the carryover of unreimbursed costs to subsequent periods, the terms of reimbursement and the unreimbursed amount should be disclosed (see also paragraph 8.13).

8.08 Rule 12b-1 plans historically have provided that a fund's board of directors may terminate the plan without any penalty to the investment company. Some 12b-1 plans provide that, upon termination, the fund's board of directors has the option, but not the requirement, to pay the distributor for any costs it incurred in excess of the cumulative CDSLs and 12b-1 fees that the distributor received. Such a plan is called a board-contingent plan. Under 12b-1 plans, including board-contingent plans, CDSL payments by shareholders are remitted to the distributor until excess costs are fully recovered or until aggregate NASD limitations on sales charges to be received are met, after which the CDSL payments are remitted to the investment company instead of to the distributor. Such CDSL payments should be offset against any 12b-1 expenses in the statement of operations.

8.09 With an **enhanced 12b-1 plan**, the investment company is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has excess costs. CDSL payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Thus, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments on plan termination.

8.10 The following table summarizes the 12b-1 plan attributes enumerated above:

	Traditional			*Enhanced*
	Compensation	*Reimbursement*		
		Nonboard-contingent	*Board-contingent*	
Annual review and approval of plan by board, with ability to terminate plan	X	X	X	X
*Fund Payment Terms**				
Payment based on average net assets	X	X	X	X
Annual or cumulative limitation, or both, based on actual distribution costs		X	X	X
Upon termination of 12b-1 plan, board has option, but not obligation, to pay excess costs			X	
Upon termination of 12b-1 plan, fund is required to continue paying 12b-1 fee to the extent the distributor has excess costs				X

8.11 A liability, with a corresponding charge to expense, for excess costs should be recognized by a fund with an enhanced 12b-1 plan. The amount of the liability should equal the cumulative distribution costs incurred by the distributor less the sum of (*a*) cumulative 12b-1 fees paid, (*b*) cumulative CDSL payments, and (*c*) future cumulative CDSL payments by current shareholders, if estimable. Any future cumulative CDSL payments should be based on (*a*) current net asset value per share, (*b*) the number of shares currently outstanding and the number of years that they have been outstanding, and (*c*) estimated shareholder persistency based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares. Changes in the liability should be recognized in the statement of operations as an expense or as a reduction of expense.

8.12 The liability should be reported at its present value, calculated using an appropriate current interest rate, if (*a*) the amount and timing of cash flows are reliably determinable and (*b*) the distribution costs are not subject to a reasonable interest charge. If these conditions are not met, the liability should be calculated without discounting to present value.

* Excludes front-end and CDSL payments, which are made by shareholders and not the fund.

8.13 A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded by a fund with a board-contingent plan when the fund's board commits to pay such costs.

8.14 For both traditional and enhanced plans, funds should disclose in their financial statements the principal terms of such plans and any plan provisions permitting or requiring payments of excess costs after plan termination. For board-contingent and enhanced plans, the aggregate amount of distribution costs subject to recovery through future payments by the fund pursuant to the plan and future CDSL payments by current shareholders should be disclosed. For enhanced plans, funds should disclose the methodology used to estimate future CDSL payments by current shareholders.

8.15 An excess of cumulative 12b-1 fees and CDSL payments to date and future CDSL payments by current shareholders over the cumulative costs incurred by the distributor should not be reported as an asset.

Minutes

8.16 In reviewing the board of directors' minutes, the auditor should note such significant items as dividend declarations, capital changes, and amendments to and continuation of contracts and agreements with such entities as the adviser, the distributor, the transfer agent, the custodian, and the underwriter. The auditor should note changes in fee structures or expense limitations for reference in auditing expenses.

Organization and Offering Costs

8.17 The provisions of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, apply to financial statements issued by investment companies in the development stage, as defined in that Statement.

8.18 A newly formed investment company incurs organization costs unless a sponsoring management company agrees to absorb such costs (see paragraph 8.4). Organization costs consist of costs incurred to establish the company and enable it legally to do business. A newly established series of a previously established investment company may also incur organization costs. In a master-feeder arrangement, these costs may be incurred at the master level, feeder level, or both. Organization costs for an investment company include, among other things, the following:

- Incorporation fees
- Legal services pertaining to the organization and incorporation of the business, drafting of bylaws, administration, custody and transfer agent agreements, and performing research and consultation services in connection with the initial meeting of directors
- Audit fees relating to the initial registration statement and auditing the initial seed capital statement of assets and liabilities

8.19 An open-end investment company, organized to offer shares of capital stock to the public continuously and to invest the proceeds from the sale of such capital stock, should not be considered organized until the company has registered securities with the SEC. Legal fees for preparing the initial registration statement are an offering cost. The SEC requires all organization costs incurred by the investment company to be presented as a liability in the investment company's "seed capital" statement of assets and liabilities, which is included in the investment company's initial registration statement.

8.20 Prior to the adoption of Statement of Position (SOP) 98-5, *Reporting on the Costs of Start-Up Activities*, organization costs were accounted for as a deferred charge and amortized to expense over the life of the entity, but not to exceed sixty months, typically on the straight-line method. Organization costs incurred subsequent to the adoption of SOP 98-5 should be charged to expense as they are incurred.

8.21 The following chart summarizes those costs that are, or are not, generally treated as organization and offering costs and the accounting required under SOP 98-5 or other generally accepted accounting principles:

Cost	*Accounting Treatment*
Incorporation fees	Expense
Audit fees related to initial registration and seed capital audit	Expense
Legal fees related to:	
• Organization and incorporation of the business	Expense
• Drafting bylaws	Expense
• Drafting administration, custody, and transfer agent agreements	Expense
• Performing research and consultation services in connection with the initial meeting of directors	Expense
• Preparing the initial registration statement	Offering cost—see paragraph 8.24
Licensing fees	Amortize over term of license
Typesetting and printing prospectus	Offering cost—see paragraph 8.24
Registration fees	Offering cost—see paragraph 8.24
Tax opinion costs related to offering of shares	Offering cost—see paragraph 8.24

8.22 Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, the sale of capital stock and investment of funds. Employee training, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and the costs of these activities are not borne directly by the investment company. However, an investment company, particularly one not engaging an agent to manage its portfolio and to perform other essential functions, may engage in such activities and may bear those costs directly during its development stage.

8.23 Offering costs include the following:

- Legal fees pertaining to the company's shares offered for sale
- SEC and state registration fees
- Underwriting and other similar costs
- Costs of printing prospectuses for sales purposes

- Initial fees paid to be listed on an exchange
- Tax opinion costs related to offering of shares
- Initial agency fees of securing the rating for bonds or preferred stock issued by closed-end funds

8.24 Offering costs of closed-end funds and investment partnerships should be charged to paid-in capital upon sale of the shares or units. Offering costs of open-end investment companies and of closed-end funds with a continuous offering period should be accounted for as a deferred charge until operations begin and thereafter amortized to expense over twelve months on a straight-line basis.

8.25 Offering costs of unit investment trusts (UITs) should be treated as follows:

- Offering costs should be charged to paid-in capital on a pro rata basis as the units or shares are issued or sold by the trust (when the units are purchased by the underwriters). Units sold to underwriters on a firm basis are considered sold by the trust, and the offering costs associated with those units should be charged to paid-in capital when the units are purchased by the underwriters.
- Offering costs that have not yet been charged to paid-in capital should be written off when it is no longer probable that the shares to which the offering costs relate will be issued in the future. It is presumed that those costs will not have a future benefit one year from the initial offering. Consequently, offering costs that remain unamortized at the end of the year should be reviewed for impairment.

Unusual Income Items

8.26 Unusual income items, such as amounts recovered from the settlement of litigation, are usually recognized in the financial statements when the investment company acquires an enforceable right, in accordance with the gain contingency provisions of FASB Statement No. 5. For items considered payment in lieu of settlement, refer to paragraph 7.50. Before an unusual item is collected, it should be valued by the board of directors, and subsequent changes in the fair value should be recorded. Items relating to specific portfolio securities are typically recorded as an adjustment to realized or unrealized gains or losses. Otherwise, the item and a subsequent revaluation should be presented as other income, if any, or as a separate income item. If the item is sufficiently material in relation to net investment income, it should be presented as a line item immediately before net investment income, unless the item is clearly identifiable with realized or unrealized gains or losses.

Form N-SAR*

8.27 Form N-SAR is the semiannual and annual report filed with the SEC by all registered management investment companies, small business investment companies, and UITs.

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* In 2003, the SEC adopted a new Form N-CSR under which a registered investment company files its annual and semi-annual shareholder reports together with the certifications of principal executive and financial officers required by Rule 30a-2 of the 1940 Act. The Form also provides for disclosure of other information relating to the investment company's code of ethics, audit committee, principal accountant fees and services, internal controls, and (for closed-end funds) proxy-voting policies.

8.28 Form N-SAR contains numerous items and must be filed with the SEC within sixty days of the end of the semiannual or annual reporting period, as applicable. UITs are required to file annual reports only. The investment company's auditors are not required to audit and report on items contained in Form N-SAR.

8.29 Form N-SAR requires a management investment company to provide an auditor's report on the investment company's internal controls. Form N-SAR states that the report should be "based on a review, study, and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities made during the audit of the financial statements. The report should disclose material weaknesses in the accounting system, the system of internal accounting control and procedures for safeguarding securities that exist as of the end of the registrant's fiscal year. Disclosure of a material weakness should include an indication of any corrective action taken or proposed." The auditor's report should be presented as an exhibit to Form N-SAR filed for the investment company's fiscal year and should be addressed to the investment company's shareholders and board of directors, dated, and signed manually. It should also indicate the city and state where issued. An illustrative report is presented in chapter 11.

8.30 The SEC has indicated that it will not regard the fact that the auditor's report is attached to Form N-SAR as acknowledgment that the auditor has reviewed the form. The auditor is not deemed to be associated with Form N-SAR and, accordingly, has no responsibility to read it.

8.31 Small business investment companies or other investment companies not required by either the 1940 Act or other federal or state laws, or rules or regulations thereunder, to have audits of their financial statements are exempt from the provisions regarding auditors' reports on internal control.

Business Combinations

8.32 Investment companies usually combine in tax-free reorganizations. In such reorganizations, shares of one company are exchanged for substantially all the shares or assets of another company. The primary purpose of such combinations is to reduce operating costs and improve performance by spreading certain fixed costs over a larger asset base. The composition of the acquired investment company's portfolio is usually less important to the acquiror than the overall size of the acquired pool of assets. Following a combination, portfolios of investment companies are often realigned, subject to tax limitations, to fit the objectives, strategies, and goals of the surviving company. Adjusting the carrying amounts of assets and liabilities or determining exchange formulas is usually unnecessary, because a significant portion of the net assets of investment companies (that is, investments) are stated at fair value and liabilities are generally short-term. However, adjustments may be necessary in certain circumstances when funds have different valuation policies (for example, valuing securities at the bid price versus the mean of the bid and asked price).

8.33 Only one of the combining companies can be the legal survivor. In certain instances, it may not be clear which of two funds constitutes the surviving entity for financial reporting purposes. Although the legal survivor would normally be considered the accounting survivor of the merger, continuity and dominance in one or more of the following areas might lead to a determination that the fund legally dissolved should be considered the accounting survivor:

- Portfolio management
- Portfolio composition
- Investment objectives, policies, and restrictions
- Expense structures and expense ratios
- Asset size

8.34 A registration statement on Form N-14 is filed in connection with a fund merger. Form N-14 is a **proxy statement**, in that it solicits a vote from the acquired fund's shareholders to approve the transaction, and a prospectus, in that it registers the acquiring fund's shares that will be issued in the transaction. Form N-14 frequently requires the inclusion of pro forma financial statements reflecting the effect of the merger.

8.35 Tax implications must be considered and monitored carefully in the planning, execution, and post-merger stages of a business combination. The tax rules that must be considered include those related to the determination that the transaction is tax-free to the funds involved and their shareholders,[1] the qualification tests affecting regulated investment companies (RICs),[2] and the accounting for tax attributes of specific accounts such as earnings and profits,[3] capital loss carryforwards, and methods of tax accounting.[4] A private letter ruling from the Internal Revenue Service (IRS) or an opinion of counsel on the tax-free treatment should be obtained. There are important differences in the tax rules affecting business combinations of RICs and non-RIC investment companies.

8.36 Merger-related expenses (mainly legal, audit, proxy solicitation, and mailing costs) are addressed in the plan of reorganization and are generally paid by the fund incurring the expense, although the adviser may waive or reimburse certain merger-related expenses, subject to SEC limits. Such costs are charged to expense currently. There are numerous factors and circumstances to consider in determining which entity bears merger-related expenses. For example, the target fund might bear the expenses when merging is an alternative to liquidating the fund. An acquiring fund might bear the expenses when its goal is the growth of its assets by acquiring the target fund.

8.37 Tax-free business combinations of investment companies are accounted for by a method that closely approximates the accounting followed for tax purposes. Companies combined in a nontaxable exchange of shares should carry forward the historical cost basis of investment securities to the surviving entity. The amount of unrealized appreciation or depreciation and the amount of undistributed investment company income of the acquired fund at the date of acquisition, if significant, should be disclosed separately to report meaningful information about the fund's performance. The acquired fund's portfolio should be monitored, as substantial turnover of the acquired fund's portfolio securities may jeopardize the tax-free status of the reorganization. If the carrying value of the acquired investment company's liabilities differs materially from their fair value on the acquisition date, refer to FASB Statement No. 141, *Business Combinations*, for guidance on recognition of the liabilities by the surviving entity.

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[1] Section 368(a) of the Internal Revenue Code (IRC) and Internal Revenue Service (IRS) Notice 88-19.

[2] Section 851 of the IRC.

[3] Treasury Regulation 1.852-12(b).

[4] Section 381 of the IRC.

8.38 The statement of operations, the statement of changes in net assets, and the financial highlights are not restated. The costs of purchases and proceeds from sales of portfolio securities that occurred in the effort to realign the fund's portfolio should be excluded in the portfolio turnover calculation. The amount of excluded purchases and sales should be disclosed in a note. (See Form N-1A, Item 9, Instruction 4(d)(iii).)

8.39 If the combination is a taxable reorganization, the fair value of the assets acquired on the date of the combination becomes their new cost basis.

8.40 Disclosures for all business combinations should include a summary of the essential elements of the combination, that is, the effective date, the number and fair value of shares issued by the surviving company, the exchange ratio, the tax status, and tax attributes. The separate and combined aggregate net assets should be presented as of the date of combination. (See appendix E, "Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies.")

Diversification of Assets

8.41 An investment company may use a worksheet such as the one in appendix D, "Worksheet for Diversified Management Investment Companies (as defined in section 5(b)(1) of the Investment Company Act of 1940)," to determine and document that it has complied with the diversification requirements stated in its registration statement. The auditor should consider reviewing that worksheet to become satisfied about the fund's representations of the diversification of its assets. Those diversification requirements may differ from the requirements under subchapter M, discussed in chapter 6.

Auditor's Responsibility for Other Information in Documents Containing Audited Financial Statements

8.42 An entity may publish various documents that contain information in addition to audited financial statements (for example, annual reports and proxies). Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of the auditor's report.

8.43 Statement on Auditing Standards (SAS) No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.04), states the following:

> The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[5] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency,

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[5] In fulfilling his responsibility under this section, a principal auditor may also request the other auditor or auditors involved in the engagement to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph.

he should consider other actions such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

8.44 SAS No. 8 provides additional guidance with respect to the auditor's responsibility for other information in documents containing audited financial statements. In September 2002, the Auditing Standards Board issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Among other things, SAS No. 98 amends SAS No. 8 to indicate that an auditor may express an opinion, in relation to the basic financial statements taken as a whole, on supplementary information and other information that has been subjected to the auditing procedures applied in the audit of the basic financial statements. In those circumstances, the auditor's report on the information should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. The auditor may report on such information using the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.12 and .14). This amendment is effective upon issuance.

Chapter 9

Unit Investment Trusts

9.01 A unit investment trust (UIT) is an investment company organized under a trust agreement and indenture or a similar instrument between the sponsor and trustee. It has no board of directors, and it issues only redeemable units of undivided interest or shares of beneficial interest, each representing a fractional undivided interest in the trust's portfolio of investment securities. Units remain outstanding until a unit holder tenders them to the trustee or sponsor for redemption or until the trust is terminated. Trust agreements usually require periodic pro rata distribution of earnings to the unit holders of the trust's entire net investment income and net realized capital gains, if any, and distribution of the proceeds of redemptions, maturities, or sales of securities in the trust, unless the proceeds are used to pay for units to be redeemed. A distinguishing feature of UITs is that the portfolio is intended to be relatively fixed; neither the sponsor nor the trustee has power to manage the portfolio. In general, securities may be sold only for limited purposes (for example, to generate proceeds to pay a redeeming unit holder).

9.02 A UIT is one of the three basic kinds of investment companies defined by the Investment Company Act of 1940 (the 1940 Act). The UIT form is used primarily as an investment vehicle to hold (*a*) a portfolio of tax-exempt bonds, corporate bonds, government bonds, and common or preferred stocks or other kinds of securities or (*b*) the shares of a particular management investment company being accumulated under a contractual plan. (See chapter 10 for a discussion of unit trusts as a funding medium for variable annuity contracts.) The form and content of financial statements of publicly held UITs are prescribed by article 6 of Regulation S-X, and for financial schedules, by rules 6-10(d) and 12-12 of Regulation S-X.

9.03 The discussion in this chapter covers fixed-income and equity UITs because the majority of UITs are of those kind. The accounting and auditing procedures for unit trusts are similar to those for other investment companies described in this Guide. (See chapter 8 for a discussion of accounting for offering costs of UITs.)

Fixed-Income and Equity UITs

9.04 Units in UITs representing self-liquidating pools of tax-exempt or taxable bonds or other taxable fixed-income securities held in custody by a corporate trustee were first offered to the investing public in the early 1960s. Trusts investing entirely or in part in equity securities have become increasingly common in the 1990s.

9.05 The principal objectives of most fixed-income UITs are to generate a consistent income stream that may be taxable or tax-exempt by investing in a diversified portfolio of securities. The principal objectives of most equity UITs are to generate dividend income and potential for capital appreciation through investment in a fixed portfolio of stocks.

9.06 A sponsoring organization, such as an investment banking firm or a broker-dealer, initiates a UIT by accumulating a group of securities of a kind specified in the trust indenture. Portfolios may range in fair value from a few million dollars to $100 million or more and may consist of many individual issues. A tax-exempt bond portfolio may be diversified by economic activity (such as education, health care, and housing) or geographic area, or it may be concentrated in a particular state to provide investors with income exempt from federal, state, or local income taxes. The portfolio may be accumulated by the sponsor over a period ranging from a few days to several weeks or longer. At the deposit date, the portfolio of securities or contracts to purchase securities is conveyed to a corporate trustee at prices defined in the trust agreement. For fixed-income UITs, these prices are usually based on offering prices, rather than bid prices, as determined by an independent **evaluator** retained by the sponsor. For equity UITs, these prices are usually based on the trustee's or evaluator's evaluation of the fair value of the securities in the portfolio. An irrevocable letter of credit is issued by a commercial bank and delivered to the corporate trustee to cover the cost and accrued interest to settlement dates or expected dates of delivery of portfolio securities. Securities offered on a when-issued basis, delayed deliveries, or the normal settlement process may cause delayed deposits. An audit of a UIT is usually performed as of the opening of business on the initial date of deposit.

9.07 The sponsoring company, underwriters, and other participants sell units of undivided interest at their public offering price, which is equal to the fair value of the underlying securities owned by the trust, including accrued interest, and other assets, if any, divided by the number of units outstanding, plus a sales charge. The sales charge is a percentage of net asset value of the trust unit, excluding accrued interest, and may be reduced on a graduated scale for sales to quantity purchasers. Upon the formation of the trust, the sponsor may realize a profit or loss on the sale of the portfolio to the trust equal to the difference between the aggregate cost of the portfolio to the sponsor and the aggregate valuation on the date of deposit. A note to the initial schedule of investments should disclose the aggregate cost of the securities to the trust and the related net gain or loss to the sponsor.

9.08 A UIT may be expandable. At the initial date of deposit, a limited amount of securities is placed in the trust and a limited number of units is issued. However, the trust agreement may provide for "expanding" the trust in size and number of units through additional deposits of securities in the trust, usually for a period of up to ninety days. The additional securities deposited must be identical to the original securities and the original proportionate relationships among securities must be maintained. The auditor may be requested to perform certain agreed-upon procedures at the subsequent deposit dates.

9.09 A UIT generally does not offer units of participation continuously. However, the sponsor usually maintains a secondary market by repurchasing units from unit holders at prices based on the aggregate bid price of the underlying securities, and by re-offering them at prices based on the aggregate bid or offering prices of the underlying securities plus a sales charge. If the sponsor does not maintain a secondary market, or does not choose to purchase the units, a unit holder can redeem his or her units at a price that is usually based on the aggregate bid price of the underlying securities. Some UITs allow unit holders to "exchange" units of the trust for other kinds of UITs offered by the sponsors based on relative net asset values, and at a reduced sales charge.

9.10 After the initial syndication by the sponsoring entity, all accounting, recordkeeping, and income and principal distribution services are performed by the trustee. The trustee distributes the accumulated income to unit holders periodically, usually monthly or quarterly, but sometimes semiannually or annually. Usually, as securities are redeemed or as they mature, the proceeds are distributed to unit holders. Investors may have the option of reinvesting the proceeds from income or principal distributions into additional units of the trust or other investment vehicles of the sponsor.

9.11 The trustee generally reports to unit holders periodically on the fair values of the underlying securities and on certain other financial information relating to the trust, as required by the trust agreement. The valuation policies are similar to those used by other investment companies. Audited financial statements[1] are usually not distributed to unit holders; however, unaudited year-end distribution information is supplied by the sponsor or trustee. The trust agreement specifies the reporting of tax and other information.

9.12 Some or all of the debt securities owned by certain trusts are covered by insurance obtained by the issuer or the trust to guarantee principal and interest payments when due. The valuation of securities in an insured portfolio is discussed in chapter 3.

Taxes

9.13 Some UITs may qualify as regulated investment companies (RICs) under subchapter M of the Internal Revenue Code (IRC) by complying with the applicable requirements (see chapter 6). They usually distribute all their taxable income and gains from sales of securities and are therefore not subject to federal income or excise taxes. However, most UITs which invest principally in tax-exempt bonds and equity securities are organized as grantor trusts. The tax requirements for a grantor trust structure are different from a RIC. A grantor trust is formed to facilitate the direct investment of its assets. If multiple classes of ownership exist, they must be incidental to the purpose of easing direct ownership (that is, senior or subordinated rights) and beneficial ownership of the trust represents proportional participation in the undivided interests of the whole. The trustee does not have the power to vary investments. Unlike a RIC, a grantor trust does not have income and asset qualification tests. Also, the taxable income flows through to the participant as it is earned by the trust; income recognition to the grantor or beneficiary does not depend on distributions from the trust. UITs structured as grantor trusts pass through principal and interest payments to the grantor or beneficiary, but the cash flows may not fully correlate with the taxable income reported.

9.14 If a UIT is a RIC and more than 50 percent of its total assets consist of securities on which interest is exempt from federal income taxes under existing law when received by a trust, the tax-exempt character of the interest is retained when distributed (net of the trust's expenses) to unit holders. Amounts realized from capital gains and paid to unit holders by the trust are taxable to the unit holder. (Chapter 6 discusses taxes in more detail.)

Illustrative Financial Statements

9.15 The financial statements of UITs are similar to those of management investment companies. When a trust is formed, the financial statements filed with the Securities and Exchange Commission (SEC) on Form S-6[2] include a statement of assets and liabilities and a schedule of investments. Subsequently, if the sponsor repurchases and re-offers trust units in the secondary

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[1] In 2003, the SEC adopted a new Form N-CSR under which a registered investment company files its annual and semi-annual shareholder reports together with the certifications of principal executive and financial officers required by Rule 30a-2 of the 1940 Act. Unit investment trusts are exempt from the requirements of Form N-CSR.

[2] See chapter 1, paragraph 1.24.

market, a posteffective amendment to Form S-6 must be filed periodically with the SEC. The financial statements included in the posteffective amendment, which are prepared in accordance with Regulation S-X, include a statement of assets and liabilities, a schedule of investments, statements of operations, and statements of changes in net assets (see illustrative statements in paragraphs 9.17 through 9.21). Audited financial statements are provided to prospective investors in the prospectus. Form S-6 requires that both the statement of operations and statement of changes in net assets cover a three-year period.

9.16 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the illustrative financial statements that follow because they are not otherwise required by generally accepted accounting principles. Such compliance disclosures include—

a. The aggregate cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 (note 8) of Regulation S-X.

b. The gross unrealized appreciation or depreciation for all securities, on a tax basis, according to rule 12-12 (note 8) of Regulation S-X.

9.17

Anytown Income Trust
First Intermediate Series
Statement of Assets and Liabilities
August 31, 20X4

Trust Property

Assets	
Investment in securities, at fair value (cost $14,591,035) (Note 1 and Schedule 1)	$13,878,788
Interest receivable	339,174
Cash	166,489
Total assets	14,384,451

Liabilities and Net Assets

Liabilities	
Trustee and evaluator fees payable	47
Accrued other expenses payable	475
Total liabilities	522
Net assets	
Balance applicable to 15,500 units of fractional undivided interest outstanding (Notes 1 and 3)	
Cost to original investors	15,475,560
Less initial underwriting commission	(619,022)
	14,856,538
Accumulated losses	(232,610)
Principal distributions to unit holders of proceeds from investment transactions	(239,999)
Net assets	$14,383,929
Net asset value per unit (15,500 units)	$ 928

The accompanying notes are an integral part of these financial statements.

9.18

Schedule 1
Anytown Income Trust
First Intermediate Series
Portfolio of Corporate Securities
August 31, 20X4

Name of issuer and title of issue	*Coupon rate (%)*	*Date of maturity or final sinking fund payment*	*Principal amount or par value*	*Fair value*	
Corporate debt obligations:					
Air transport					
Flying Tiger Lines Incorporated equipment trust certificates	9.000	10/01/X1	$ 931,000	$ 912,380	
Total air transport (Percentage of net asset value)			931,000	912,380	(6.3%)
Banking					
Dominion Bankshares notes	9.500	4/01/X3	1,000,000	1,022,500	
First Maryland Bancorp notes	9.750	11/01/X3	250,000	252,500	
Southeast Banking Corporation notes	10.000	5/01/X3	218,000	224,267	
Total banking (percentage of net asset value)			1,468,000	1,499,267	(10.4%)
Utilities					
Utah Power & Light Company first mortgage bonds	4.500	6/01/X2	12,100,000	11,467,141	
Total utilities (percentage of net asset value)			12,100,000	11,467,141	(79.7%)
Total debt (percentage of net asset value)			$14,499,000	$13,878,788	(96.5%)

The accompanying notes are an integral part of these financial statements.

9.19

Anytown Income Trust
First Intermediate Series
Statements of Operations

	For the year ended August 31, 20X4	*From March 23, 20X3 (date of deposit) through August 31, 20X3*
Investment income		
Interest income	$1,258,975	$554,509
Expenses (Note 1)		
Trustee's fee	14,063	5,411
Evaluator's fee	1,350	375
Other	1,083	351
Total expenses	16,496	6,137
Net investment income	1,242,479	548,372
Realized and unrealized gain (loss) on investments (Note 1)		
Net realized losses from investment transactions	(12,738)	(12,765)
Net change in unrealized appreciation (depreciation) of investments	(738,828)	26,581
Net gain (loss) on investments	(751,566)	13,816
Net increase in net assets resulting from operations	$ 490,913	$562,188

The accompanying notes are an integral part of these financial statements.

9.20

Anytown Income Trust
First Intermediate Series
Statements of Changes in Net Assets

	For the year ended August 31, 20X4	*From March 23, 20X3 (date of deposit) through August 31, 20X3*
Increase (decrease) in net assets resulting from operations		
Net investment income	$ 1,242,479	$ 548,372
Net realized losses on investment transactions	(12,738)	(12,765)
Net change in unrealized appreciation (depreciation) of investments	(738,828)	26,581
Net increase in net assets resulting from operations	490,913	562,188
Distributions to unit holders (Note 2)		
Accrued income as of the date of deposit	5,182	360,787
Net investment income	1,231,408	54,303
Proceeds from investment transactions	129,000	110,999
Total distributions	1,365,590	526,089
Increase (decrease) in net assets	(874,677)	36,099
Net assets		
Beginning of period	15,258,606	15,222,507
End of period	$14,383,929	$15,258,606

The accompanying notes are an integral part of these financial statements.

9.21

Anytown Income Trust
First Intermediate Series
Notes to Financial Statements

1. Summary of Significant Accounting Policies

The Trust was organized on March 23, 20X3, under the laws of the Commonwealth of Massachusetts by a Trust Indenture and Agreement, and is registered under the Investment Company Act of 1940. The significant accounting policies of the Trust include the following:

Basis of presentation. The financial statements are presented on the accrual basis of accounting.

Investment in marketable securities. Security transactions are recorded on a trade date basis. Investments owned are carried at fair value, which is the closing bid price on the last day of trading during the period, except that fair value on the date of deposit (March 23, 20X3) represents the cost to the Trust based on offering prices for investments at that date. The difference between cost and fair value is reflected as unrealized appreciation (depreciation) of investments. Realized gains (losses) from securities transactions are determined for federal income tax and for financial reporting purposes on the identified cost basis.

Income taxes. No provision for federal income taxes has been made in the accompanying financial statements because the Trust has elected and intends to continue to qualify for the tax treatment applicable to regulated investment companies under the Internal Revenue Code. Under existing law, if the Trust so qualifies, it will not be subject to federal income tax on net investment income and capital gains distributed to unit holders. Distributions to unit holders of the Trust's net investment income will be taxable as ordinary income to unit holders. Capital gains distributions will be taxable as capital gains to unit holders.

Investment expenses. The Trust pays a fee for trustee services to XYZ Bank that is based on $0.75 per $1,000 of outstanding investment principal. In addition, a fixed fee of $35 is paid to a service bureau for portfolio valuation at least weekly and more often at the discretion of the trustee.

2. Distributions of Income and Redemption of Units

The Trust Agreement requires that the net investment income and net realized capital gains (if any) of the Trust, and also the proceeds from the sale, redemption, or maturity of securities (to the extent that the proceeds are not used to redeem units), be distributed to unit holders monthly.

The Agreement also requires the Trust to redeem units tendered for redemption, to the extent that such units are not purchased by the sponsor, at a price determined based on bid prices of the securities of the Trust.

As of August 31, 20X4, the components of distributable earnings on a tax basis were as follows:

Undistributed net investment income		$ 505,140
Unrealized depreciation of investments	(712,247)	
Accumulated net realized loss from investment transactions	(25,503)	
		$(232,610)

3. Original Cost to Unit Holders

The original cost to investors[3] represents the aggregate initial offering price as of the date of deposit exclusive of accrued interest. The initial underwriting commission and investors' original cost of units, as shown on the statement of assets and liabilities, are based upon the assumption that the maximum sales commission was charged for each initial purchase of units.

4. Financial Highlights

	8/31/X4	*8/31/X3*
Per Share Operating Performance:		
Net asset value, beginning of period	$984.43	$982.10
Income from investment operations		
Net investment income	80.16	35.38
Net realized and unrealized gain (loss) on investment transactions	(48.49)	0.89
Total from investment operations	31.67	36.27
Less distributions	(88.10)	(33.94)
Net asset value, end of period	$928.00	$984.43
Total Return:	3.22%	3.51%
Ratios as a Percentage of Average Net Assets:		
Expenses	0.11%	0.09%
Net investment income	8.38%	8.21%

[3] This information is required by Regulation S-X and is not otherwise required by generally accepted accounting principles.

Chapter 10

*Variable Contracts—Insurance Companies**

Separate Accounts

10.01 This chapter discusses separate accounts of life insurance companies. Separate accounts, also known as variable accounts, are used to support variable annuity contracts and variable life insurance policies (hereinafter referred to together as "variable contracts"). Separate accounts are registered investment companies under the Investment Company Act of 1940 (the 1940 Act), without an applicable exemption.[1] A variable contract is both a security registered under the Securities Act of 1933 (the 1933 Act) and an insurance policy filed with and approved and regulated by state insurance departments.

10.02 A variable annuity or life insurance contract[2] is a contractual arrangement that combines some features of an investment company (the contract holder assumes the risk of investment gain or loss) with certain traditional insurance features (the insurance company assumes the risk of mortality and administrative expenses). A significant difference between a traditional or fixed annuity and a variable annuity is that, in sponsoring a fixed annuity, the insurance company assumes the risk of investment gain or loss and guarantees the contract holder a specified interest rate. In a variable annuity, the contract holder assumes the risk of investment gain or loss because the value of the contract holder's account varies with the investment experience of the specific portfolio of securities (that is, the securities held in the separate account). In both fixed annuities and variable annuities, the insurance company (rather than the separate account) assumes the mortality risk and administrative expenses for a contractually fixed fee or fees. Certain other nontraditional annuity products have emerged in recent years, such as indexed annuities. Indexed annuities represent, in effect, a combination of a fixed annuity with a derivative so that the investor is exposed to investment risk without investing in a specific portfolio of securities. Fixed and indexed annuities are not further discussed in this Guide.

10.03 Variable contracts are funded by and issued through separate accounts of insurance companies. A registered separate account is either an open-end investment company or a unit investment trust (UIT). A separate

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* In July 2003, AcSEC issued an exposure draft of a proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies, which provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

A final pronouncement is expected to be issued in the fourth quarter of 2003. The final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

[1] This chapter does not apply to separate accounts that are established as investment vehicles for pension plans, such as those described in paragraphs 7.41 to 7.43 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*. The financial statements of those separate accounts should be prepared in accordance with the practices established by chapter 7 of this Guide for investment companies.

[2] Hereinafter, references to variable annuity contracts also refer to variable life insurance contracts, unless otherwise indicated.

account is not a legal entity, but an accounting entity with accounting records for variable contract assets, liabilities, income, and expenses segregated as a discrete operation within the insurance company. The insurance company's other separate accounts and its general account do not affect the results of the variable contract separate account. The combined separate accounts must file an annual statement with state insurance regulatory authorities. The separate account is not taxed separately for federal and state tax purposes; it is included with the operations of the insurance company. However, under federal regulation, variable annuity and variable life products are securities. For purposes of the 1940 Act, a separate account is an independent entity, separate from the insurance company, and cannot rely on the 1940 Act's exemption for insurance companies.

10.04 The following approaches are used to invest the underlying assets of variable contracts:

a. Direct investment by the separate account in individual securities (the separate account is an open-end investment company)

b. Investment in a registered investment company formed to receive proceeds from such contract holders (the separate account is a UIT)

c. Investment in a registered investment company that sells shares to the public (the separate account is a UIT), an approach available only for tax-qualified variable annuities

10.05 Similar to an open-end investment company organized as a series fund, separate accounts are frequently structured with multiple subaccounts. Each subaccount has a unique investment strategy, and in the case of a separate account organized as a UIT, individual subaccounts will invest in different underlying investment companies. This structure allows contract holders to allocate their amount invested among various investment choices. Financial position and results of operations are maintained separately for each subaccount within the separate account.

History

10.06 In 1959, the Supreme Court ruled that variable annuities constitute securities subject to registration with the Securities and Exchange Commission (SEC). In 1964, the U.S. Court of Appeals for the Third Circuit ruled that separate accounts funding variable annuities are investment funds that are separable from the insurance company and therefore not exempted from the 1940 Act. Variable annuities became increasingly popular in the late 1960s after federal legislation encouraged self-employed individuals to establish pension accounts.

10.07 The insurance industry introduced investment annuities in the mid-1960s as a further variation of variable annuities. Investment annuities allowed individual contract holders to select specific investment vehicles. Custodian accounts were established with a third party, usually a bank, in which contract holders deposited cash or other assets. The insurer received an annual fee, usually based on a percentage of the invested assets. Although the account's assets were owned by the insurer, they were segregated for the benefit of contract holders, who directed their investments and could sell or exchange them at any time. Further, it was possible to fully or partially redeem investment annuities before the annuity payout period began by paying the insurer a penalty. Assets remaining in an account at the contract holder's death accrued to the insurer as a terminal premium. Investment annuities are no longer treated as annuities for federal income tax purposes.[3]

10.08 The first variable annuity wrapped using mutual fund shares as its underlying investment vehicle (a "wraparound" annuity) was developed in 1972. A wraparound annuity differs from other variable annuities because it is based on shares of an underlying investment vehicle and not on a pro rata share of individual stocks, bonds, and other investments owned by a separate account. The wraparound annuity separate account's assets typically are invested in a corporate bond fund, a common stock fund, a liquid assets fund, or in some combination of these funds. The contract holder may allocate all or a portion of each payment among those investments.

10.09 Variable life insurance was first offered for sale in the United States in 1976, after having been successful for several years in the Netherlands, the United Kingdom, and Canada. Early variable life insurance policies were fixed premium contracts providing coverage for the whole of life. Death benefits and cash values varied in relation to the investment experience of a separate pool of assets. Today, most variable life insurance policies are of the variable universal life design. These newer variable life policies allow the policy owner to vary the amount of premium paid and, depending on premiums and investment experience, may expire without value.

Product Design

10.10 A significant objective of a variable annuity contract is to provide an investment that is responsive to changes in the cost of living and that can be used to accumulate investment funds before retirement and to pay benefits after retirement. Before retirement, the accumulated value of the individual account varies with investment performance and may be withdrawn by the contract holder in whole or in part with possible surrender charges, tax liabilities, or both, including possible tax penalties. A contract holder may elect to receive the accumulated value of the individual account at retirement in a lump sum, in periodic payments that are fixed or variable, or in a combination of both (depending on the options available under the particular contract). Periodic payments also may extend for various durations—for example, over the life of the annuity holder, over a defined period, or over the combined lives of the annuity holder and a designated beneficiary (a "joint and survivor" annuity).

10.11 If a lump sum is elected, the contract owner receives the account value at the payment date. If a fixed payment is chosen, the contract owner will receive a fixed periodic payment that is based upon the account value at the date of conversion to payout, and actuarial considerations. See paragraphs 10.17 and 10.18 for a discussion of the methodology typically used when a variable benefit option is selected. More recent innovations permit contract owners to obtain a lump-sum "commutation" of a portion of the contract even after payments commence, guarantees of minimum account or payment values, or periodic payments adjusted for inflation.

10.12 The provisions of variable annuity contracts can require contract holders to make periodic payments to the sponsoring insurance company, or the contract can call for a single premium payment or provide for other methods of payment. Products typically are designed as front-end loaded or back-end loaded, as specified in the prospectus. Products with a front-end load deduct sales charges from the contract holder's purchase payments, whereas

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[3] Revenue Ruling 80-274.

back-end loaded products reduce the surrender value by contractually specified charges, if any. The net payment is used to buy **accumulation units** of the separate account. The value of the separate account at any time is allocated among contract holders based on the number and value of their accumulation units representing their interest in the separate account. The concept of the accumulation unit and the unit value are analogous to fund shares and net asset value per share. The total value of the contract holder's accumulation units is the amount available to the contract holder at any time.

10.13 If a contract holder dies during the accumulation period, the death benefit varies, depending on the terms of the contract. The value of the death benefit is determined as of the valuation date and paid according to the applicable laws and regulations governing the payment of death benefits. Death benefits may be based upon the contract value at the time of death, contract value as of a stated anniversary date, or the total premiums paid. If a contract holder dies after the annuity commencement date, the death benefit is the amount specified in the annuity option selected by the contract holder (under certain options, the death benefit can be zero).

10.14 Typically, the insurance company charges the separate account a specified amount for investment management services (if the separate account is organized as an open-end investment company), an amount for administrative expenses, and fees for mortality and expense risks assumed. Certain of these charges (for example, administrative charges) may be recovered through an annual contract charge, effected as a redemption of units. The insurance company assumes the risk that the annuitant's mortality will be less favorable (that is, he or she will live longer) than the rates assumed (mortality risk) and that administration and investment expenses will exceed the fee charged (expense risk). The mortality risk charge also covers the risk that the account value at death will be insufficient to fund the minimum benefit.

10.15 The insurance company also assumes the mortality risk by incorporating annuity rates into the contract, which cannot be changed. Variable annuity payments are computed based on contractually specified mortality tables. The insurance company retains the longevity risk regardless of the method of payout the contract holders elect and must continue payments although contract holders or their beneficiaries, depending on the payment options selected, live longer than anticipated. The insurance company may bear additional mortality risk if it offers a guaranteed minimum death benefit, under which a minimum payment is made to a beneficiary if the annuityholder dies before the payout period commences. To compensate the insurance company for assuming this mortality risk, a mortality risk premium, which is an amount usually computed as a percentage of the daily net asset value of the separate account, is deducted from the separate account. If the mortality risk premium is insufficient to compensate it for its costs, the loss is assumed by the insurance company. Conversely, if the mortality risk premium is greater than its costs, the excess is the insurance company's gain.

10.16 The insurance company undertakes to pay the expenses of the separate account and may or may not charge the account a direct fee for the services rendered. Whether or not any fees are charged for specific services, the insurance company charges an expense risk premium to the separate account. This charge is to compensate the insurance company for accepting the risk that expense charges will be insufficient to cover the company's cost of providing administrative and other services, including payments to third parties, to the separate account. The **annuity contract** usually provides that this expense risk charge may vary, but sets a maximum.

10.17 The amount of the first annuity payment of a variable annuity is determined by applying a factor in the applicable annuity table to the contract value as of the date on which annuity payments begin, in accordance with the annuity option specified in the application. The first payment is divided by the value of an annuity unit, a unit of measure used to calculate variable annuity payments and to establish the number of annuity units for each monthly payment. The number of annuity units for a particular annuitant, determined on the annuity commencement date, remains fixed during the annuity payment period.

10.18 Under a variable benefit option, the amounts of the second and subsequent payments are determined by multiplying the fixed number of annuity units by the annuity unit value on the date on which the payments are due. Thus, subsequent payments vary in accordance with the underlying investment performance of the separate account and the resulting annuity unit value.

10.19 Variable life insurance policies have many of the same *variable* features as variable annuities. The premium for a variable life policy, less an expense or sales load and mortality charge, is invested in a separate account. The policy owner may specify, within limits, where this cash value is to be invested. Several options are available, including various kinds of money market, bond, and equity funds.

10.20 The policy's death benefit and cash value vary directly with the performance of the fund or funds selected. However, a guaranteed minimum death benefit is available, providing a floor of protection regardless of the investment performance of the fund or funds. Investment risk in excess of any guaranteed minimum death benefit is borne by the policy owner. The insurance company retains only expense and mortality risk, as well as the risk of paying guaranteed minimum death benefits in excess of the value of the fund(s) in which the policyholder invested.

10.21 In all other respects, a variable life insurance policy works like a traditional whole life policy, and a variable universal life policy works like a common universal life policy. All of the normal riders and attachments are typically available on variable products. Further information on life insurance contracts can be found in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities.*

Contracts in Payout (Annuitization) Period

10.22 As stated previously, a variable annuity payment option provides an annuity with payment amounts that are not predetermined, but vary according to the results of the underlying investment. The payout (annuitization) period begins when amounts accumulated under the contract (the contract value) are applied under the method-of-payment option selected by the contract holder. At each financial reporting date, the separate account financial statements include an aggregate amount of net assets allocated to future contract benefits for the contracts in the payout (annuitization) period.

10.23 The net assets allocated to future contract benefits, sometimes referred to as the annuity reserve account, is the total of an actuarial computation of the discounted amount of the expected annuity payments for each contract or group of contracts based principally on the annuity payments at the current annuity unit value multiplied by the individuals' expected mortality rates based upon an annuity table.

10.24 For variable life contracts, the insurance company charges the separate account for the cost of fixed premium variable life insurance coverage based on traditional methodology, which can be calculated using standard techniques. The charge for variable universal life insurance policies is usually determined in accordance with the National Association of Insurance Commissioners (NAIC) Universal Life Insurance Model Regulation.

SEC Registration

10.25 A separate account is established by resolution of the insurance company's board of directors in accordance with the insurance laws of the state of domicile. It is subject to policy-form approval and other requirements in each state in which the company offers the contract. Courts have determined that variable contracts and separate accounts are subject to registration and regulation under the 1933 and 1940 Acts, respectively. The registrant is the separate account.

10.26 In addition to accumulation units and net assets allocated to future annuity contract benefits established at the separate account level, as described previously, certain separate accounts withhold the mortality and expense payments from the insurance company. Instead of paying the charges to the insurance company in cash, the separate account may apply accumulation units, or net assets, to the insurance company's own account. This may occur either at the discretion of the sponsoring insurance company to build investible assets, or at the requirement of the state insurance commission. (Certain state insurance commissioners have required certain separate accounts to withhold payments to the insurance company.) The purpose of this holdback is to protect contract holders against adverse mortality in the event the insurance company is unable to fulfill its responsibilities to insulate the separate account from mortality risk. If the holdback is maintained in the form of accumulation units or otherwise participates in the investment experience of the separate account, it should be reported in net assets by the separate account under the caption "Retained in variable account by insurance company." If the holdback does not participate in the investment experience of the separate account (that is, it is fixed in amount), it should be reported by the separate account as a liability.

10.27 Initially, variable contract issuers registered as management investment companies because they invested their assets directly in securities and therefore resembled typical mutual funds in their investment objectives. The 1940 Act has many technical requirements for a management investment company, including requirements for an elected board of directors and proxy statements. The requirements for a board of directors and proxy statements in certain circumstances, among others, are inconsistent with the legal status of the separate account, which is not a legal entity existing apart from the life insurance company.

10.28 Accordingly, since 1969, most separate accounts have registered under the 1940 Act as UITs to avoid some technical requirements for companies registered as management investment companies under that Act. Further, the form of a UIT satisfies the need for separate accounting for the performance of specific pools of assets of group annuity contracts, personal contracts, and annuity contracts subject to different tax rules. The UIT form may also accommodate lower expense charges and more flexibility in adding new products and changing the features (for example, expenses) of current products. (Changes to fund level expenses can be achieved through contract owner approval but without the need to amend the contracts.)

10.29 In 1985, the SEC adopted two registration forms for use by separate accounts offering variable annuity contracts that register under the 1933 and 1940 Acts. Form N-3 is the registration form for separate accounts registered as management investment companies. Form N-4 is the registration form for UITs.

10.30 Variable life separate accounts, as UITs, registered under the 1940 Act on Form N-8B-2 and register their securities under the 1933 Act on Form S-6. In April 2002, the SEC adopted a new Form N-6 to replace Forms N-8B-2 and S-6 (Release No. 33-8088), with the objectives of improving disclosure and streamlining the registration process by introducing a single form tailored directly to variable life products. All new registration statements filed on or after December 1, 2002, for separate accounts that are registered as unit investment trusts and that offer variable life insurance policies must comply with Form N-6. All insurance company separate accounts that are registered as unit investment trusts and that currently offer variable life insurance policies with effective registration statements must comply with Form N-6 for post-effective amendments that are annual updates to their registration statements filed on or after December 1, 2002, and no later than December 1, 2003.

Auditing Considerations

10.31 Because most features of a variable annuity and a variable life contract are similar to those of a mutual fund, the auditing guidance in other chapters of this Guide also applies to these variable contracts. However, major differences exist between variable annuities and mutual funds in accounting for contracts in the payout period and in the calculation of the net assets allocated to contracts in the payout period (annuity reserve account). In addition, when a separate account organizes as a UIT investing in a mutual fund, other audit issues can arise. Finally, the auditor should be aware of issues arising due to unique aspects of the taxation of insurance companies.

10.32 Mortality and interest rate assumptions (based on the annuity option selected by the contract holder, the contract holder's age at issue, and the date of issue of the annuity) are the two most significant factors in determining the annuity reserve account. The auditor should become satisfied with the annuity reserve account by consulting published tables for the appropriate factors and testing that those factors have been appropriately applied to the master file containing all outstanding contracts in the payout period. Similarly, the auditor should become satisfied with the determination of amounts receivable from or payable to the insurance company based on its mortality experience on contracts in the payout period (see paragraph 10.34). A broad outline of procedures to be followed in auditing actuarial computations is described in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities.*

10.33 For variable life contracts, the net assets maintained by the separate account (excluding any amounts held for the account of the insurance company) are analogous to the cash value of the underlying insurance policies. The liability for death benefits is held by the insurance company.

10.34 As stated previously, the insurance company assumes certain risks in issuing variable annuities and variable life contracts. If mortality experience on annuity contracts in the payout period runs favorably or unfavorably to the insurer's estimate (see paragraphs 10.22–10.23), it does not affect the separate account but creates an amount payable to or receivable from the insurance company, respectively. Among the factors that should be considered in examining the financial statements of a separate account funding a variable annuity is the insurance company's ability to perform if the variable annuity's assets are insufficient to meet the variable annuity's obligations.

10.35 When the separate account is organized as a UIT, certain considerations can arise due to the relationship between the separate account and the underlying investment company. If the auditor of the separate account is not the auditor of the fund, the separate account auditor should consider what effect, if any, this has on the audit. The fiscal year end of the separate account and the underlying investment company are often the same, and the audited financial statements of the fund will usually be available to the separate account auditor as evidential matter with respect to the fund's value. The separate account auditor should consider what communications with the fund auditor are appropriate and, in general, should consider what other steps are appropriate, including those steps described in paragraphs 5.62 through 5.86, to rely on the work of another auditor or perform other procedures.

10.36 If the underlying fund and the separate account have different year ends, questions may arise regarding auditing investment valuation. As noted in the preceding paragraph, the auditor of the separate account usually has available audited financial statements to provide evidential matter with respect to the value of the investment in the fund. When the fund is not audited at the separate account year-end date, the auditor should consider what other audit procedures might be appropriate to substantiate the separate account's valuation, including procedures discussed in paragraphs 5.67 through 5.70.

10.37 The auditor's report is typically addressed to the board of directors of the sponsoring insurance company and the contract holders of the separate account.

Taxation of Variable Contracts

10.38 Variable annuity contracts are designed for use primarily by individuals for personal savings or retirement plans, which, under the provisions of the Internal Revenue Code (IRC), may be qualified or nonqualified plans. Variable life contracts are designed for individuals to provide market-sensitive cash surrender values and death benefits. The ultimate effect of federal income taxes on the contract value, annuity payments, cash values, death benefits, and economic benefit to the contract owner, annuitant, or beneficiary depends on the separate account's tax status, the purpose for which the contract is purchased, and the individual's tax and employment status. The discussion in this section is general and is not intended to be an all-inclusive and comprehensive treatise on the current tax status of variable annuities.

10.39 If an annuity contract qualifies as such under the IRC, a contract holder is generally not taxed on increases in the value of the contract until he or she receives payment in a lump sum or as an annuity under the settlement option elected, nor is he or she taxed upon the investment buildup in cash values. Although the assets and liabilities of the separate account are segregated from the sponsoring life insurance company's regular business, it is not considered a separate taxable entity. The tax treatment of the separate account depends upon the character of the contracts held by the separate account. If the contracts qualify as "variable contracts" that are "adequately diversified" (see paragraphs 10.47 through 10.49 below), then section 817 of the IRC dictates the taxation of the separate account. If the contracts do not qualify as variable or are not adequately diversified, then the activity of the separate account will be governed by the tax rules applicable to life insurance companies under subchapter L of the IRC. The separate account is not subject to the tax rules applicable to regulated investment companies (RICs) under subchapter M of the IRC.

10.40 Under section 817 of the IRC, reinvested investment income is applied to increase insurance company reserves under the contracts, and the increase in reserves is deductible from income. Usually a provision for federal income taxes on investment income or gains is not required; therefore, a provision is not made in the variable annuity separate account financial statements.

10.41 Section 817(g) of the IRC provides that a variable annuity contract will be taxed in the same manner as a traditional or fixed annuity if the payments under the variable contract are computed based on recognized mortality tables and the investment return of the individual segregated account.

10.42 When the UIT approach was developed using mutual funds as the underlying investment, insurers relied on several tax rulings as the basis for treating mutual fund wraparounds similarly to traditional variable annuities.

10.43 However, in April 1977, the Internal Revenue Service (IRS) issued Revenue Ruling 77-85, which concluded that because contract holders have control over the assets and investments, they own the underlying assets and are liable for tax on their earnings. Despite Revenue Ruling 77-85, the IRS issued favorable letter rulings on wraparound annuities between 1977 and 1980. In Revenue Ruling 80-274, however, the IRS again concluded that the position of a contract holder of an annuity wrapped around a savings account is as if the investment had been maintained or established directly with a savings and loan association. Thus, the contract holder is taxed on a current basis on the separate account income.

10.44 On September 25, 1981, the IRS issued Revenue Ruling 81-225, which held that, for federal income tax purposes, the insurance company and not the contract holder will be considered the owner of mutual fund shares underlying investments for an annuity contract, provided that such shares are unavailable to the public. Accordingly, under that ruling, if the mutual fund shares are not available to the public, the contract holder is not treated as the owner of the shares, and dividends applicable to such shares are not currently includable in the contract holder's gross income.

10.45 Many argue that Congress intended to resolve the "investor control" issue with the enactment of the diversification requirements (described in paragraph 10.47) and that the aforementioned rulings no longer apply. However, the IRS appears to continue to exercise authority in this area and has not conceded that the diversification requirements were intended to resolve this issue.

10.46 Section 817(h) of the IRC and the regulations thereunder require the investments of a separate account (or the underlying mutual fund, if the separate account is a UIT) to be "adequately diversified" to qualify as an annuity contract under section 72 of the IRC (qualification under section 72 is necessary to avoid current taxation of both current and "built-up" earnings of the contract). In order for the separate account to be adequately diversified, the fair value of the largest holding may not exceed 55 percent of the fair value of total assets, the two largest holdings may not exceed 70 percent, the three largest holdings may not exceed 80 percent, and the four largest holdings may not exceed 90 percent (measured on a quarterly basis). Regulation 1.817-5(b)(1) further describes what assets must be included in the calculation and what assets may be excluded.

10.47 U.S. government securities are subject to the section 817(h) diversification rules. The treatment of U.S. government securities for purposes of determining separate account diversification is different from that applied to RICs. Under section 817(h), each government agency or instrumentality is treated as a separate issuer for purposes of diversification testing.

10.48 As an alternative to the general diversification standards described above, IRC section 817(h)(2) provides "safe harbor" diversification standards that are similar to those for RICs and are often easier to administer. However, the "safe harbor" diversification rules differ from those of RICs in that the total assets of the separate account represented by cash, cash items (including receivables), U.S. government securities, or securities of other RICs may not exceed 55 percent of the value of total assets in the account. Regulation 1.817-5(b)(3) provides special rules that apply to a segregated asset account with respect to variable life insurance contracts.

10.49 Section 72(s) of the IRC provides that a contract should not be treated as an annuity for tax purposes unless it provides for certain required distributions in the event of the contract holder's death.

10.50 Section 72(q) of the IRC imposes certain penalties on early withdrawals from annuity contracts.

10.51 The federal excise tax rules governing the timing and amounts of distributions do not apply to insurance-related mutual funds if no taxable investors are present. Further, in organizing the separate account, the sponsoring insurance company may invest taxable seed money of up to $250,000 without subjecting the fund to the excise tax rules (IRC section 4982).

10.52 Dividends and distributions from the fund to the separate account are usually reinvested. As a result, some "insurance funds" do not actually pay any dividends or distributions. Rather, they satisfy their fund level tax qualification tests by using a procedure known as "consent dividends" (IRC section 565). Under this procedure, with annual written consent from each investor (that is, the separate accounts), distributions are deemed to be passed through from the fund to the investors. This is manageable operationally because, in practice, few separate accounts tend to invest in a fund.

Illustrative Financial Statements

10.53 The financial statements illustrated in this chapter are for variable annuity separate accounts registered as UITs. For separate accounts with multiple subaccounts, the financial position and results of operations should be presented separately for each subaccount. This kind of arrangement is presented with individual columns for each subaccount. The total information for the separate account as a whole is not meaningful. Accordingly, a subaccount that is similar to a series mutual fund, is the reporting entity and the auditor's report should be modified to cover the individual subaccounts (see paragraph 11.09). The financial statements of a subaccount may also be presented as if the subaccount were a separate entity. Variable annuity separate accounts registered as management investment companies would prepare financial statements that conform to those presented in chapter 7, although certain financial statement notes that follow would also apply. Under the requirements of SEC Form N-4, variable annuity separate accounts registered as UITs present a period-end statement of assets and liabilities, a statement of operations for the most recent year, and a statement of changes in net assets for the most recent two years in the same manner as a registered investment company. This format is illustrated in the exhibit. Variable life separate accounts registered as UITs on Form N-6 also would follow the form of the exhibit. Certain contract charges, for example, cost of insurance, would be shown on the statement of changes in net assets, which is similar to the presentation of annuity contract charges.

10.54 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account. These disclosures include the following:

- The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 of Regulation S-X
- The components of net assets presented as a separate schedule or in the notes to the financial statements according to rule 6-05.5 of Regulation S-X. However, the net asset value per unit at the beginning and end of each period and the total net assets at the end of the period are to be provided for the most recent five years.

The Form S-6* expense table requires the presentation, under separate captions, of the expense ratio of each separate account and the underlying fund(s) in which it may invest, as well as a combined expense ratio. The financial highlights table in the separate account's financial statements need not aggregate these ratios; however, the table should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expenses incurred indirectly by the underlying funds.

* In April 2002, the SEC adopted a new Form N-6 to replace Forms N-8B-2 and S-6 (Release No. 33-8088), with the objectives of improving disclosure and streamlining the registration process by introducing a single form tailored directly to variable life products. See paragraph 10.30 for effective date information.

10.55

ABC Variable Annuity Separate Account I of ABC Life Insurance Company Statement of Assets and Liabilities December 31, 20X3

	Money Market	*Equity Index*
Assets:		
ABC Investment Fund		
Investments at fair value:		
Money Market Portfolio, 57,231,590 shares (cost $57,231,590)	$57,231,590	$ —
Equity Index Portfolio, 23,961,595 shares (cost $325,054,036)	—	350,797,752
Total assets	57,231,590	350,797,752
Liabilities:		
Payable to ABC Life Insurance Company	—	46,109
	$57,231,590	$350,751,643
Net assets:		
Accumulation units	$57,231,590	$349,750,644
Contracts in payout (annuitization) period	—	610,108
Retained in Separate Account I by ABC Life Insurance Company	—	390,891
Total net assets	$57,231,590	$350,751,643
Units outstanding	4,136,795	19,674,291
Unit value (accumulation)	$ 13.83	$ 17.83

The accompanying notes are an integral part of these financial statements.

10.56

ABC Variable Annuity Separate Account I
of ABC Life Insurance Company
Statement of Operations
for the Year Ended December 31, 20X3

	Money Market	*Equity Index*
Income:		
Dividends	$4,602,399	$ 6,450,878
Expenses:		
Mortality and expense risk	548,224	1,753,874
Administrative charges[4]	182,741	584,624
Net Investment Income	3,871,434	4,112,380
Realized gains (losses) on investments		
Realized gain on sale of fund shares	—	4,050,008
Realized gain distributions	—	400,900
Realized gain	—	4,450,908
Change in unrealized appreciation during the year	—	20,728,111
Net increase in net assets from operations	$3,871,434	$29,291,399

The accompanying notes are an integral part of these financial statements.

[4] If, under the annuity contract, the administrative charge is levied as a direct charge to the contract holders' accounts, rather than against the separate account, this would be included as an item separate from contract transactions in the statement of changes in net assets. In such cases, the exclusion of the direct charges from the expense ratios appearing in the financial highlights should be noted. If the charge is applied uniformly to all accounts based on the value of the contract holder's account, consideration should be given to indicating the effect of the charge on contract holder costs (expressed as a percentage of net assets) in the note.

10.57

ABC Variable Annuity Separate Account I of ABC Life Insurance Company Statement of Changes in Net Assets for the Years Ended December 31, 20X3 and 20X2

	Money Market		*Equity Index*	
	20X3	*20X2*	*20X3*	*20X2*
Increase in net assets from operations:				
Net investment income	$ 3,871,434	$ 3,534,624	$ 4,112,380	$ 1,100,710
Realized gains	—	—	4,450,908	462,877
Unrealized appreciation during the year	—	—	20,728,111	22,480,579
Net increase in net assets from operations	3,871,434	3,534,624	29,291,399	24,044,166
Contract transactions:				
Payments received from contract owners	14,367,366	17,444,822	37,527,318	11,075,691
Transfers between subaccounts (including fixed account), net	(15,063,795)	(18,267,246)	155,175,016	59,808,957
Transfers for contract benefits and terminations	(11,945,485)	(10,017,075)	(4,238,812)	(1,639,933)
Contract maintenance charges	(40,061)	(51,366)	(210,505)	(65,202)
Adjustments to net assets allocated to contracts in payout period	—	—	6,500	—
Net increase (decrease) in net assets from contract transactions	(12,681,975)	(10,890,865)	188,259,517	69,179,513
Increase (decrease) in amounts retained in Variable Annuity Account I, net	—	—	90,967	(122,904)
Total increase (decrease) in net assets	(8,810,541)	(7,356,241)	217,641,883	93,100,775
Net assets at beginning of period	66,042,131	73,398,372	133,109,760	40,008,985
Net assets at end of period	$57,231,590	$66,042,131	$350,751,643	$133,109,760

The accompanying notes are an integral part of these financial statements.

10.58

ABC Variable Annuity Separate Account I of ABC Life Insurance Company Notes To Financial Statements

1. Organization

The ABC Variable Annuity Separate Account I (Separate Account I), a unit investment trust registered under the Investment Company Act of 1940 as amended, was established by ABC Life Insurance Company (ABC) on April 1, 20XX and exists in accordance with the regulations of the New York Insurance Department. Separate Account I is a funding vehicle for individual variable annuity contracts. Separate Account I currently consists of two investment divisions, Money Market and Equity Index, each of which is treated as an individual separate account. Each investment division invests all of its investible assets in the corresponding portfolio of ABC Investment Fund, Inc.

Under applicable insurance law, the assets and liabilities of Separate Account I are clearly identified and distinguished from ABC's other assets and liabilities. The portion of Separate Account I's assets applicable to the variable annuity contracts is not chargeable with liabilities arising out of any other business ABC may conduct.

2. Significant Accounting Policies

Investments are made in the portfolios of the ABC Investment Fund and are valued at the reported net asset values of such portfolios, which value their investment securities at fair value. Transactions are recorded on a trade date basis. Income from dividends, and gains from realized gain distributions, are recorded on the ex-distribution date.

Realized gains and losses on the sales of investments are computed on the basis of the identified cost of the investment sold.

Net assets allocated to contracts in the payout period are computed according to the 1983a Individual Annuitant Mortality Table. The assumed investment return is 3.5 percent unless the annuitant elects otherwise, in which case the rate may vary from 3.5 percent to 7 percent, as regulated by the laws of the respective states. The mortality risk is fully borne by ABC Life Insurance Company and may result in additional amounts being transferred into the variable annuity account by ABC Life Insurance Company to cover greater longevity of annuitants than expected. Conversely, if amounts allocated exceed amounts required, transfers may be made to the insurance company.

The operations of Separate Account I are included in the federal income tax return of ABC Life Insurance Company, which is taxed as a life insurance company under the provisions of the Internal Revenue Code (IRC). Under the current provisions of the IRC, ABC Life Insurance Company does not expect to incur federal income taxes on the earnings of Separate Account I to the extent the earnings are credited under the contracts. Based on this, no charge is being made currently to the Separate Account I for federal income taxes. ABC Life Insurance Company will review periodically the status of this policy in the event of changes in the tax law. A charge may be made in future years for any federal income taxes that would be attributable to the contracts.

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported therein. Actual results could differ from these estimates.

3. Purchases and Sales of Investments

The cost of purchases and proceeds from sales of investments for the year ended December 31, 20X3 were as follows:

	Purchases	*Sales*
Money Market Sub-Account	$ 13,855,466	$22,666,007
Equity Index Sub-Account	245,503,854	37,232,105
	$259,359,320	$59,898,112

4. Expenses and Related Party Transactions

ABC Life Insurance Company deducts a daily charge from the net assets of Separate Account I equivalent to an effective annual rate of 0.25 percent for administrative expenses and 0.75 percent for the assumption of mortality and expense risks. ABC Life Insurance Company also deducts an annual maintenance charge of $35 for each contract from the ABC Retirement Reserves Contract value. The maintenance charge, which is recorded as a redemption in the accompanying statement of changes in net assets, is waived on certain contracts.

Additionally, during the year ended December 31, 20X3, management fees were paid indirectly to ABC Management Company, an affiliate of ABC Insurance Company in its capacity as advisor to ABC Investment Fund. The Fund's advisory agreement provides for a fee at the annual rate of 0.15 percent of the average net assets of the Money Market Fund and 0.45 percent of the average net assets of the Equity Index Fund.

[Other: Consider disclosures of other fees to affiliates not otherwise disclosed, such as sales load charges retained by the insurance company].

5. Changes in Units Outstanding

The changes in units outstanding for the years ended December 31, 20X3 and 20X2 were as follows:

	Money Market		*Equity Index*	
	20X3	*20X2*	*20X3*	*20X2*
Units Issued	1,075,828	1,346,281	11,530,377	5,387,478
Units Redeemed	(1,967,393)	(2,191,438)	(268,220)	(115,368)
Net Increase (Decrease)	(891,565)	(845,157)	11,262,157	5,272,110

6. Unit Values[5, *]

A summary of unit values and units outstanding for variable annuity contracts, net investment income ratios and the expense ratios, excluding expenses of the underlying funds, for each of the five years in the period ended December 31, 20X3, follows.

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[5] See AICPA *Technical Practice Aids*, section 6910, *Investment Companies*, paragraphs .11 through .15, related to reporting financial highlights by separate accounts.

[*] In July 2003, AcSEC issued an exposure draft of a proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies, which provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

A final pronouncement is expected to be issued in the fourth quarter of 2003. The final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

Units	Net Assets Unit Value	Net Assets (000s)	Net Investment Income as a % of Average Net Assets	Expenses as a % of Average Net Assets**	Total Return
Money Market Investment Division					
December 31					
20X3 4,136,795	$13.83	$57,232	5.25%	1.00%	5.30%
20X2 5,028,360	13.13	66,042	5.02	1.00	5.07
20X1 5,873,517	12.50	73,398	8.46	1.00	8.54
20X0 2,058,353	11.52	23,705	8.23	1.00	8.31
20W9 967,550	10.63	10,291	6.24***	1.00***	6.30
7/1/W9* 500,000	10.00	5,000			

Units	Net Assets Unit Value	Net Assets (000s)	Net Investment Income as a % of Average Net Assets	Expenses as a % of Average Net Assets**	Total Return
Equity Index Division					
December 31					
20X3 19,674,291	$17.83	$350,752	2.23%	1.00%	12.68%
20X2 8,412,134	15.82	133,110	2.35	1.00	24.16
20X1 3,140,024	12.74	40,009	3.12	1.00	(9.50)
20X0 3,879,972	14.08	54,630	3.24	1.00	11.94
20W9 2,162,080	12.58	27,195	3.98	1.00	6.20

* Commenced operations.

** For the year ended December 31, excluding the effect of the expenses of the underlying fund portfolios and charges made directly to contract holder accounts through the redemption of units.

*** Annualized.

Chapter 11

Independent Auditor's Reports and Client Representations

11.01 The following auditor's reports on financial statements illustrate pertinent items discussed in this Guide, but they do not cover all the diverse circumstances that may occur in practice. It is essential, therefore, that the auditor modify the reports according to the requirements of the particular circumstances. Financial reporting for publicly registered investment companies is governed by rules of the Securities and Exchange Commission (SEC) (for example, Regulation S-X) and there may be differences between this Guide and SEC rules.

Report on Financial Statements of Nonregistered Investment Companies

11.02 The following form of auditor's report may be used to express an unqualified opinion on the financial statements of a nonregistered investment company:

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Investment Company

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company (the Company), including the schedule of investments, as of December 31, 20X4, and the related statements of operations, cash flows,[1] changes in net assets, and the financial highlights for the year then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement.

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[1] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirements to provide a statement of cash flows. See chapter 7 for further discussion.

[2] This form of report is prescribed by SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.08), as amended by SAS No. 93, *Omnibus Statement on Auditing Standards—2000*. AU section 508 states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. Auditing Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 states that if the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. This can be done by modifying this sentence as follows (new language is shown in italics):

We conducted our audit in accordance with auditing standards generally accepted in the United States of America *and in accordance with International Standards on Auditing.*

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations, its cash flows,[3] changes in its net assets, and financial highlights for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
February 21, 20X5

11.03 In April 2003, the AICPA Auditing Standards Board issued Auditing Interpretation No. 16 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508), entitled "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940." According to this Interpretation, if financial statements of an investment partnership that is exempt from SEC registration do not include the required Schedule of Investments disclosures that are listed in paragraph 7.12 of this Guide, and it is practicable for the auditor to determine them or any portion thereof, the auditor should include the information in his or her report expressing the qualified or adverse opinion. Footnote 15 of AU section 508 indicates that it is practicable to provide the missing information if "the information is reasonably obtainable from management's accounts and records and . . . providing the information in the report does not require the auditor to assume the position of a preparer of financial information." Ordinarily, it would be practicable for the auditor to obtain and present the information about investments constituting more than 5 percent of net assets called for by section (*b*) of the disclosure requirement described in paragraph 7.12 of this Guide. However, due to the need to categorize the investments for the purpose of preparing the schedule called for by section (*a*) of the disclosure requirement described in paragraph 7.12 of this Guide, the auditor might be in the position of preparer of financial information and, therefore, would not include the schedule in his or her report. In rare cases, the Schedule of Investments information may be so limited that the auditor may conclude that disclosure of the entire Schedule is practicable.

11.04 Following is an illustration of a report that expresses a qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of this Guide:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

[3] See footnote 1.

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock-fair value $3,280,000 (Consumer nondurable goods)
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value-fair value $4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, . . .

11.05 An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows.[4] This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock-fair value $3,280,000 (Consumer nondurable goods)[5]
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value-fair value $4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [*describe the nature of the information that it is not practicable to present in the auditor's report*].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, . . .

Reports on Financial Statements of Registered Investment Companies

11.06 The auditor's report on the audit of a registered investment company's financial statements must state specifically that securities have been

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[4] AU section 508.36 discusses the factors the auditor considers in deciding whether to issue a qualified opinion or an adverse opinion.

[5] In the absence of a Schedule of Investments containing categorizations by type, country or geographic region, and industry, such categorizations should be provided only if readily ascertainable from management's accounts and records. The auditor should not assign such categorizations if management has not done so.

confirmed or physically examined to substantiate their existence.[6] That statement is made because of the high relative importance of investments in securities to the business of an investment company. Auditors must address their reports on financial statements of a registered investment company to the company's shareholders and board of directors.[7]

11.07 The following form of auditor's report may be used to express an unqualified opinion on the financial statements of a registered investment company:

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Investment Company

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of investments, as of December 31, 20X4, and the related statements of operations and cash flows[8] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended.[9] These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[10] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ

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[6] Securities and Exchange Commission (SEC), *Codification of Financial Reporting Policies*, section 404.03a.

[7] Section 32(a) of the Investment Company Act of 1940 (the 1940 Act).

[8] See footnote 1.

[9] In an open-end fund's registration statement, an auditor must opine on at least the most recent two of the five years of financial highlights presented in a registered investment company's annual report. In the fund's registration statement, the auditor must opine on all five years presented.

[10] This form of report is prescribed by SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.08), as amended by SAS No. 93, *Omnibus Statement on Auditing Standards—2000*. AU section 508 states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. Auditing Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 states that if the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. This can be done by modifying this sentence as follows (new language is shown in italics):

We conducted our audit in accordance with auditing standards generally accepted in the United States of America *and in accordance with International Standards on Auditing.*

Investment Company as of December 31, 20X4, the results of its operations and its cash flows[11] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X5

11.08 The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. When broker confirmations are not received and alternative procedures are performed, the sentence may be modified to read "and brokers or by other appropriate auditing procedures where replies from brokers were not received." Also, if securities were physically inspected or subject to other extended procedures for purposes of the audit, the report should be modified to state that those procedures were performed.

11.09 The auditor's report needs to be modified for a fund referred to as a "series fund" because of the uniqueness of the financial statements that have evolved to present its financial position, results of operations, and cash flows. The financial position, results of operations, and cash flows of some or all of the portfolios or other entities constituting the series are frequently presented in separate columns. The financial statements of the series may also be presented as if the series were a separate entity. In both cases, the scope of the audit should be sufficient to enable the auditor to report on the individual financial statements of each series constituting the fund.

11.10 The following illustration is for a multicolumnar presentation of all of the portfolios constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Series Investment Company

We have audited the statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company comprising the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios as of December 31, 20X4, and the related statements of operations and cash flows,[12] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 11.07.*]

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of each of the portfolios constituting the XYZ Series Investment Company, as of December

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[11] See footnote 1.

[12] See footnote 1.

31, 20X4, the results of their operations and cash flows[13] for the year then ended, the changes in their net assets for each of the two years in the period then ended, and their financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X5

11.11 The following illustration is for a presentation of one of the portfolios or entities constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Series Investment Company

We have audited the accompanying statement of assets and liabilities, including the schedule of investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company [the Company]) as of December 31, 20X4, and the related statements of operations and cash flows[14] for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 11.07.*]

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 20X4, and the results of its operations and its cash flows[15] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X5

11.12 When the financial statements contain securities whose fair values were estimated by the board of directors in the absence of readily ascertainable fair values,[16] and the auditor concludes that the valuation procedures are

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[13] See footnote 1.

[14] See footnote 1.

[15] See footnote 1.

[16] In January 2003, the ASB issued Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

In the future, the ASB plans to issue an audit guide that will include guidance on auditing fair value measurements and disclosures relating to specific assets, liabilities, components of equity, or transactions.

inadequate or unreasonable, or that the underlying documentation does not support the valuation, the auditor should express a qualified opinion in a manner similar to the following:

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Investment Company

[*Same first and second paragraphs as in the report illustrated in paragraph 11.07.*]

As explained in Note 2, the financial statements include securities valued at $________ (________ percent of net assets), whose fair values have been estimated by the Board of Directors in the absence of readily ascertainable fair values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of fair value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine the securities' estimated fair values. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and financial highlights of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations and its cash flows[17] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X5

Where the deficiencies in procedures and documentation are sufficiently serious or pervasive to suggest that the financial statements as a whole do not present financial position and results of operations in accordance with generally accepted accounting principles, an adverse opinion may be more appropriate than a qualified opinion.

11.13 The following form of report is used in connection with a review of semiannual financial statements[18] in accordance with standards established by the American Institute of Certified Public Accountants (AICPA):

Independent Accountant's Review Report

To the Shareholders and
Board of Directors of
XYZ Investment Company

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[17] See footnote 1.

[18] In November 2002, the ASB issued SAS No. 100, *Interim Financial Information*, which supersedes SAS No. 71 of the same name. SAS No. 100 provides additional guidance on performing reviews of interim financial information. The term *interim financial information* means financial information or statements covering a period less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end. SAS No. 100 is effective for interim periods within fiscal years beginning after December 15, 2002. Earlier application of the provisions of this Statement is permitted.

We have reviewed the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of investments, as of June 30, 20X5, and the related statements of operations, changes in net assets, and financial highlights for the six-month period ended June 30, 20X5. These interim financial statements and financial highlights are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants.[19] A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial statements and financial highlights referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the statement of changes in net assets for the year ended December 31, 20X4, and financial highlights for each of the five years in the period ended December 31, 20X4, and in our report dated January 21, 20X5, we expressed an unqualified opinion on such statement of changes in net assets and financial highlights.

Independent Accountant
Anytown, USA
August 7, 20X5

Report on Examinations of Securities Pursuant to Rules 17f-1 and 17f-2 Under the Investment Company Act of 1940

11.14 The following form of report is used for examinations of securities conducted pursuant to rules 17f-1 and 17f-2 of the Investment Company Act of 1940 (the 1940 Act).[20] Paragraph (b)(4) of rule 17f-1 requires that all registered investment companies whose securities are maintained in the custody of a member of a national securities exchange have an independent public accountant conduct an examination of such securities three times per year (at each of the annual and semiannual period ends and at one other date, chosen by the accountant, during the fiscal year). Paragraph (f) of rule 17f-2 requires that all registered investment companies that maintain custody of their own securities, as defined in the rule, have an independent public accountant conduct an examination of such securities three times per fiscal year, at least two of which shall be chosen by the accountant without prior notice to the investment company. The SEC staff requires that the examination be conducted to the first level of nonaffiliation, that is, confirmations of security holdings may be relied

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[19] For reviews of nonregistered investment companies, reference should be made to Statements on Standards for Accounting and Review Services (SSARSs) issued by the AICPA Accounting and Review Services Committee.

[20] SEC, *Codification of Financial Reporting Policies*, section 404.01a (Accounting Series Release 27) describes the nature of the examination to be made and the content of the auditor's report.

upon to verify existence and ownership only if they are received from a nonaffiliate, such as the Depository Trust Company or the Federal Book Entry System. If a portion of an investment company's portfolio is not maintained in the custody of a member of a national securities exchange or held by the investment company, the provisions of rules 17f-1 and 17f-2 do not apply to those securities. This report follows the examination engagement provisions of Chapter 6, "Compliance Attestation" (AICPA, *Professional Standards*, vol. 1, AT sec. 601) of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification*, and is illustrated below for an examination pursuant to rule 17f-2.

This illustrative report should be used when a practitioner expresses an opinion on management's assertion about compliance with the requirements of subsections (b) and (c) of rule 17f-2 under the Investment Company Act of 1940. SSAE No. 10 enables true direct reporting on subject matter. However, practitioners should be aware that despite the new attestation guidance, the SEC staff continues to require that registrants file a written assertion to accompany their report.

Independent Accountant's Report

To the Board of Directors
XYZ Investment Company

We have examined management's assertion, included in the accompanying Management Statement Regarding Compliance With Certain Provisions of the Investment Company Act of 1940, that XYZ Investment Company (the Company) complied with the requirements of subsections (b) and (c) of rule 17f-2[21] under the Investment Company Act of 1940 (the Act) as of August 31, 20X4. Management is responsible for the Company's compliance with those requirements. Our responsibility is to express an opinion on management's assertion about the Company's compliance based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. Included among our procedures were the following tests performed as of August 31, 20X4, and with respect to agreement of security purchases and sales, for the period from April 30, 20X4 (the date of our last examination), through August 31, 20X4 [*itemize all that apply*]:

- Count and inspection of all securities located in the vault of [*Custodian*] in [*location*] without prior notice to management[22]
- Confirmation of all securities held by institutions in book entry form [*specify each institution, that is, the Federal Reserve Bank of (City), The Depository Trust Company, and so on*]
- Confirmation of all securities hypothecated, pledged, placed in escrow, or out for transfer with brokers, pledgees, or transfer agents
- Reconciliation of all such securities to the books and records of the Company and the Custodian

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[21] Subsection (b)(l) and (b)(6) of rule 17f-1.

[22] The phrase "without prior notice to management" should be deleted if the procedures were not performed on a surprise basis.

- Confirmation of all repurchase agreements with brokers/banks and agreement of underlying collateral with [*Custodian*] records
- Agreement of [*insert number*] security purchases and [*insert number*] security sales or maturities since our last report from the books and records of the Company to broker confirmations

We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on the Company's compliance with specified requirements.

In our opinion, management's assertion that XYZ Investment Company complied with the requirements of subsections (b) and (c) of rule 17f-2 of the Investment Company Act of 1940 as of August 31, 20X4, with respect to securities reflected in the investment account of the Company is fairly stated, in all material respects.

This report is intended solely for the information and use of management and the Board of Directors of XYZ Investment Company and the Securities and Exchange Commission and is not intended to be and should not be used by anyone other than these specified parties.

Independent Accountant
Anytown, USA
October 21, 20X4

Management Statement Regarding Compliance With Certain Provisions of the Investment Company Act of 1940[23]

We, as members of management of XYZ Investment Company (the Company), are responsible for complying with the requirements of subsections (b) and (c) of rule 17f-2, "Custody of Investments by Registered Management Investment Companies," of the Investment Company Act of 1940. We are also responsible for establishing and maintaining effective internal controls over compliance with those requirements. We have performed an evaluation of the Company's compliance with the requirements of subsections (b) and (c) of rule 17f-2 as of August 31, 20X4, and from [*last examination date*] through August 31, 20X4.

Based on this evaluation, we assert that the Company was in compliance with the requirements of subsections (b) and (c) of rule 17f-2 of the Investment Company Act of 1940 as of August 31, 20X4, and from [*last examination date*], through August 31, 20X4, with respect to securities reflected in the investment account of the Company.

XYZ Investment Company

By:

[*Signature*]
____

[*Name and title of appropriate operating official—CEO / COO*]

Report on Examinations of Securities Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940

11.15 The following form of report is used for examinations of securities conducted pursuant to paragraph a(5) of rule 206(4)-2 under the Investment

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[23] Alternatively, management's assertion may be included in a representation letter. Accordingly, the auditor's report should be modified to reflect this alternative in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, as amended. SSAE No. 10 enables true direct reporting on subject matter. However, practitioners should be aware that despite the new attestation guidance, the SEC staff continues to require that registrants file a written assertion to accompany their report.

Advisers Act of 1940. This rule requires that all registered investment advisers (or persons associated with the adviser) who have custody or possession of client funds, as defined, have an independent public accountant conduct an examination on a surprise basis once every calendar year.* This report follows the provisions of Chapter 6, "Compliance Attestation" (AICPA, *Professional Standards*, vol. 1, AT sec. 601) of SSAE No. 10, *Attestation Standards: Revision and Recodification*.

This illustrative report should be used when a practitioner expresses an opinion on management's assertion about compliance with certain provisions of rules 204-2(b) and 206(4)-2 of the Investment Advisers Act of 1940. SSAE No. 10 enables true direct reporting on subject matter. However, practitioners should be aware that despite the new attestation guidance, the SEC staff continues to require that registrants file a written assertion to accompany their report.

Independent Accountant's Report

To the Board of Directors of
XYZ Investment Advisers, Inc.

We have examined management's assertion, included in the accompanying Management Statement Regarding Compliance With Certain Provisions of the Investment Advisers Act of 1940, that XYZ Investment Advisers, Inc. (the Company) complied with certain provisions of rules 204-2(b) and 206(4)-2 of the Investment Advisers Act of 1940 as of and during the period ended September 30, 20X4. Management is responsible for the Company's compliance with those requirements. Our responsibility is to express an opinion on management's assertion about the Company's compliance based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. Included among our procedures were the following tests performed as of September 30, 20X4 [*itemize all that apply*]:[24]

- Count and inspection of all securities located in the vault of the Company in [*location*] or in [*location*] of [*persons associated with the Company*] without prior notice to management
- Confirmation of all cash and securities held by [*specify each custodian bank and broker*] in the name of the Company as agent or trustee for clients

* In July of 2002, the SEC proposed amendments to the Custody requirements under the Investment Advisers Act (Release No. IA 2044). This rule would significantly change the scope of entities subject to the surprise examination under Rule 206(4)-2 of the Investment Advisers Act. If adopted, investment advisers who have custody of client assets and deposit those assets with a qualified custodian who sends monthly account statements to the advisers' customers would be relieved of the annual surprise examination requirements. In addition, pooled investment vehicles, such as hedge funds, would be exempt from the custody requirements provided the entity is audited annually and the investment adviser sends the audited financial statements to investors within 90 days after year-end. Readers should be alert for any final rule.

[24] SEC, *Codification of Financial Reporting Policies*, section 404.01b (Accounting Series Release 103) describes the nature of the examination to be made and the content of the auditor's report. Inspections and confirmations of client cash and securities at or with the custodians and confirmations of client balances with such clients should be performed for all balances. Confirmations of client accounts that have been closed or where funds have been returned to them since the last examination, however, may be performed on a test basis.

- Reconciliation of all such cash and securities to books and records of client accounts maintained by the Company
- Confirmation with all clients of the detail of cash and securities held by the Company on behalf of such clients[25]
- Confirmation with clients of [*insert number*] accounts that were closed or for which funds were returned to the client

We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on the Company's compliance with specified requirements.

In our opinion, management's assertion that XYZ Investment Advisers, Inc. complied with the requirements of subparagraphs (1) and (2) of rule 206(4)-2(a) under the Investment Advisers Act of 1940 as of September 30, 20X4, and has complied with rule 204-2(b) and the requirements of subparagraphs (3) and (4) of rule 206(4)-2(a) under the Act for the period from [*prior examination date*] through September 30, 20X4, is fairly stated, in all material respects.

This report is intended solely for the information and use of management and the Board of Directors of XYZ Investment Advisers, Inc. and the Securities and Exchange Commission *(if applicable, also specify state securities administrators the report is required to be filed with)* and is not intended to be and should not be used by anyone other than these specified parties.

Independent Accountant
Anytown, USA
October 21, 20X5

Management Statement Regarding Compliance With Certain Provisions of the Investment Advisers Act of 1940[26]

We, as members of management of XYZ Investment Advisers, Inc. (the Company) are responsible for complying with the requirements of rule 204-2(b), "Books and Records to be Maintained by Investment Advisers," and rule 206(4)-2, "Custody or Possession of Funds or Securities of Clients," of the Investment Advisers Act of 1940 (the Act). We are also responsible for establishing and maintaining effective internal controls over compliance with the rule 204-2(b) and rule 206(4)-2 requirements. We have performed an evaluation of the Company's compliance with certain provisions of rule 204-2(b) and rule 206(4)-2 as of September 30, 20X4, and during the period from [*prior examination date*], through September 30, 20X4. Based on this evaluation, we assert that the Company was in compliance with the Act as described below:

Rule 204-2(b) under the Act requires that an investment adviser who has custody or possession of funds or securities of any client must record all transactions for such clients in a journal and in separate ledger accounts for each client and must maintain copies of confirmations of all transactions in such accounts and a position record for each security in which a client has an interest.

In addition, rule 206(4)-2(a) provides, in general, that it shall constitute a fraudulent, deceptive, or manipulative act or practice for any investment adviser who has custody or possession of funds or securities of clients to do any act or to take any action with respect to any such funds or securities unless (1) all such securities are segregated, marked for identification, and held in safekeeping in a reasonably safe place; (2) (i) the funds are deposited and maintained in one or more bank accounts that contain only clients' funds, (ii)

[25] The report should delineate procedures performed for (*a*) confirmation replies received with exception and (*b*) confirmation requests for which replies were not received. The presentation of procedures performed should be sufficiently specific for the reader to understand the nature and extent of the procedures performed.

[26] See footnote 23.

such account(s) are maintained in the name of the investment adviser as agent or trustee for such clients, and (iii) the investment adviser maintains certain appropriate records with respect to such accounts; (3) immediately after accepting such funds and securities, the investment adviser notified the client in writing of the place and manner in which they will be maintained; and (4) not less frequently than once every three-month period, each client is sent an itemized statement showing debits, credits, and transactions in the client's account during the period and the funds and securities held at the end of the period.

XYZ Investment Advisers, Inc.

By:

[*Signature*]

[*Name and title of appropriate adviser*]

Report on Internal Control Required by The SEC Under Form N-SAR

11.16 The following is an illustration of the independent auditor's report on a registered investment company's internal control based on the results of procedures performed in obtaining an understanding of internal control and assessing control risk in connection with the audit of the investment company's financial statements. These procedures should include the review, study, and evaluation of the financial reporting information system, and control and control activities for safeguarding securities required by the instructions to Form N-SAR. This report should reflect any material weaknesses present as of the fiscal year-end date.

Independent Auditor's Report

To the Shareholders and
Board of Directors of
XYZ Investment Company

In planning and performing our audit of the financial statements of XYZ Investment Company for the year ended December 31, 20X4, we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and to comply with the requirements of Form N-SAR, not to provide assurance on internal control.

The management of XYZ Investment Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. Generally, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles. Those controls include the safeguarding of assets against unauthorized acquisition, use, or disposition.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that it may become inadequate because of changes in conditions or that the effectiveness of the design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control and its operation, including controls for safeguarding securities, that we consider to be material weaknesses as defined above as of December 31, 20X4.[27]

This report is intended solely for the information and use of management and the Board of Directors of XYZ Investment Company and the Securities and Exchange Commission and is not intended to be and should not be used by anyone other than these specified parties.

Independent Auditor
Anytown, USA
February 14, 20X5

Report for a Closed-End Fund Security Agency Rating

11.17 The following is an example of an agreed-upon procedures report to be issued to a closed-end fund in connection with maintaining a security agency rating. This report is in accordance with Chapter 2, "Agreed-Upon Procedures Engagements" (AICPA, *Professional Standards*, vol. 1, AT sec. 201), of SSAE No. 10, *Attestation Standards: Revision and Recodification*. The auditor should refer to the trust indentures or articles supplementary of the relevant security to understand the necessary procedures. Since such procedures may be included in the documents, it is often advisable for the auditor to be involved in the drafting stage to prevent the inclusion of inappropriate procedures. The auditor ordinarily should ascertain whether the users have a clear understanding of the procedures to be performed by discussing the nature of management's assertion and the procedures with the users (including the fund and rating agency). Procedures should be pertinent and provide a reasonable basis for any findings. Such procedures should be specifically stated and agreed to in a written engagement letter.

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors of
XYZ Closed-End Fund
and
(Rating Agency [Agencies],
Bond Trustee [Remarketing Agents],
and other parties as required by governing document)

We have performed the procedures enumerated below, which were agreed to by [*list specified parties—see above salutation*], solely to assist you in evaluating

[27] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and should state that these weaknesses do not affect the report on the financial statements. The last sentence of the fourth paragraph of the report should be modified as follows:

> However, we noted the following matters involving the (control environment, accounting system, control procedures, or procedures for safeguarding securities) and its (their) operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of XYZ Investment Company for the year ended December 31, 20X4, and this report does not affect our report thereon dated February 14, 20X5.

[A description of the material weaknesses that have come to the auditor's attention would follow. Also, subitem 77B of the instructions to Form N-SAR states, "disclosure of a material weakness should include an indication of any corrective action taken or proposed."]

the accompanying Portfolio Valuation Reports (the Reports) of XYZ Closed-End Fund (the Fund) as of March 31, 20X4, as specified in section [*number*] of the [*governing document*] dated as of February 15, 20X4. The Fund's management is responsible for the portfolio valuation reports. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. In performing the procedures enumerated below, we have relied on information provided by sources external to the Fund without further investigation.

The procedures and associated findings are as follows:

1. We recalculated the discounted eligible portfolio fair value and eligible portfolio fair value calculations with respect to issue size, issuer diversification, and industry diversification and found such calculations to be mathematically correct. We have made no independent verification of management's classification of portfolio securities by issuer or industry.

2. We compared the preferred stock basic maintenance amount calculation with the definition of the basic maintenance amount in the [*governing document*], noting agreement. We recalculated the preferred stock basic maintenance amount and found it to be mathematically correct. We have made no independent verification of management's estimate of projected expenses as required to compute the basic maintenance amount.

3. We recalculated the excess discounted funds for the preferred stock basic maintenance amount by deducting the preferred stock basic maintenance amount from the total discounted value of the fund and found the results to be mathematically correct within $1.

4. We compared [*indicate test basis, if applicable*] the [*Rating Agency's*] ratings on corporate bonds, issuer name, issue size, and coupon rate listed in the Reports to the March 20X4 [*Rating Agency's*] Bond Guide and found them to be in agreement.

5. We compared the prices for each issue used in calculating the fair value of investment securities in the Reports to the lower of the two bid prices on a report provided by [*Custodian Bank*] and found them to be in agreement. We understand that the Fund provides the price to the Custodian, and the Custodian receives confirmation of these prices from brokers. We have made no independent verification of the fair value of the investment securities listed in the Reports.

6. We compared each security included in the Reports with the definition of eligible portfolio property, as described in the [*governing document*], and found them to be in agreement. We have made no independent verification of the accuracy of the description of the investment securities listed in the Reports.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the accompanying Portfolio Valuation Reports of XYZ Closed-End Fund. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our procedures do not provide a legal determination on XYZ Closed-End Fund's compliance with the requirements of the [*governing document*].

This report is intended solely for the information and use of [*list or refer to specified parties—see above salutation*] and is not intended to be and should not be used by anyone other than these specified parties.

Independent Accountant
Anytown, USA
April 30, 20X4

Reports on Processing of Transactions by a Transfer Agent[28]

11.18 The following illustrates a report to be issued on the policies and procedures placed in operation at a transfer agent and tests of operating effectiveness. This form of report is prescribed by Statement on Auditing Standards (SAS) No. 70, *Service Organizations*[29] (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and assumes that the report has two attachments:

a. A description of the transfer agent's control activities that may be relevant to a user (that is, fund) organization's internal control

b. A description of control activities for which tests of operating effectiveness were performed, the control objectives the control activities were intended to achieve, the tests applied, and results of the tests

Independent Auditor's Report

To ABC Service Corp.

We have examined the accompanying description of the transfer agent controls applicable to ABC Service Corp. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of ABC Service Corp.'s controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily and user organizations applied the controls contemplated in the design of ABC Service Corp.'s controls, and (3) such controls had been placed in operation as of June 30, 20X5. The control objectives were specified by the management of ABC Service Corp. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

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[28] Pursuant to the New York Stock Exchange requirement under rule 906.02, "Transfer Agent Registrar Agreement-Type A," when a transfer agent also acts as registrar for a single security issue (such as the case for closed-end funds), the transfer agent's independent public accountant is required to issue a report regarding the segregation of duties between the transfer agent and registrar functions. Such a report typically covers a period of time rather than being stated as of a specific date.

[29] In September of 2002, the Auditing Standards Board (ASB) issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Among other things, SAS No. 98 amends SAS No. 70, *Service Organizations* (AU sec. 324.57–.60), to require a service auditor to inquire of management about subsequent events. The previous guidance, in Auditing Interpretation No. 6 of SAS No. 70, stated that a service auditor should consider inquiring of management about subsequent events. SAS No. 98 also rescinds Auditing Interpretation No. 6 of SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003. Earlier application is permissible.

For more information on SAS No. 70 readers should refer to the Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*, which includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of ABC Service Corp.'s controls that had been placed in operation as of June 30, 20X5. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily and user organizations applied the controls contemplated in the design of ABC Service Corp.'s controls.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from July 1, 20X4, to June 30, 20X5. The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of ABC Service Corp. and to their auditors to be taken into consideration, along with information about internal control at user organizations, when making assessments of control risk for user organizations. In our opinion, the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from July 1, 20X4, to June 30, 20X5. However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.[30]

The relative effectiveness and significance of specific controls at ABC Service Corp. and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at ABC Service Corp. is as of June 30, 20X5, and information about tests of the operating effectiveness of specific controls covers the period from July 1, 20X4, to June 30, 20X5. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the transfer agent is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.[31]

This report is intended solely for the use of management of ABC Service Corp., its customers, and the independent auditors of its customers.

Independent Auditor
Anytown, USA
July 31, 20X5

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[30] This sentence should be added when not all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness.

[31] This form of report is prescribed by SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.54). Auditing Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods," of AU section 324 allows auditors to expand this report to describe the risk of projecting an evaluation of the controls to future periods because of changes to the system or controls, or the failure to make needed changes to the system or controls. This can be done by modifying this sentence as follows (new language is shown in italics):

> Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes *made to the system or controls, or the failure to make needed changes to the system or controls,* may alter the validity of such conclusions.

11.19 The following is an example of a report to be issued on the annual study and evaluation of a transfer agent's internal control as required to be filed with the SEC pursuant to rule 17Ad-13 of the Securities Exchange Act of 1934. This form of report is derived from Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" (AICPA, *Professional Standards*, vol. 1, AT sec. 501), of SSAE No. 10, *Attestation Standards: Revision and Recodification*. The AICPA was granted a "no action" position by the SEC in April 1995 to consider such report to be in compliance with rule 17Ad-13.

This illustrative report should be used when a practitioner expresses an opinion on management's assertion about the effectiveness of an entity's internal control. SSAE No. 10 enables true direct reporting on subject matter. If practitioner examines and reports directly on an entity's effectiveness of internal control (vs. the responsible party's written assertion), the practitioner should refer to paragraph 5.48 of SSAE No. 10 for an example of the report to be used.

Independent Accountant's Report

To the Board of Directors
of Example Bank

We have examined management's assertion, included in its representation letter dated December 15, 20X5, that "Example Bank maintained effective internal control, including the appropriate segregation of responsibilities and duties, over the transfer agent and **registrar** functions, as of October 31, 20X5, and that no material inadequacies as defined by rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934 existed at such date." Example Bank's management is responsible for maintaining effective internal control over transfer agent and registrar functions. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included a study and evaluation of internal control over the transfer agent and registrar functions, using the objectives set forth in rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934. Those objectives are to provide reasonable, but not absolute, assurance that securities and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control over the transfer agent and registrar functions to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that Example Bank maintained effective internal control, including the appropriate segregation of responsibilities and duties, over the transfer agent and registrar functions, and that no material inadequacies existed as defined by rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934 as of October 31, 20X5, is fairly stated, in all material respects, based on the criteria established by rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934.

This report is intended solely for the information and use of management and the Board of Directors of Example Bank and the Securities and Exchange

Commission and is not intended to be and should not be used by anyone other than these specified parties.

Independent Accountant
Anytown, USA
December 15, 20X5

Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards

11.20 A presentation of an investment firm's past performance in managing proprietary or client funds can be a powerful tool for attracting new clients and maintaining the firm's client base. To promote fair representation, full disclosure, and greater comparability in investment performance presentations, the Association for Investment Management and Research (AIMR) has developed the AIMR Performance Presentation Standards (AIMR-PPS® standards). Although compliance with the AIMR-PPS standards is voluntary, an investment firm's claim of compliance with the AIMR-PPS standards is widely regarded as providing a competitive advantage. SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards,* provides guidance to practitioners for engagements to examine and report on aspects of an investment firm's compliance with the AIMR-PPS standards (a Level I verification engagement). It also provides guidance on engagements to examine and report on the performance results of specific composites in conformity with the AIMR-PPS standards (a performance examination [Level II]). Such examination engagements should be performed pursuant to Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification (AICPA, Professional Standards*, vol. 1, AT sec. 101). SSAE No. 10 permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate. The following reports present both reporting options.

11.21 The following are example reports to be issued on Level I verification engagements. Practitioners should be aware that the AIMR-PPS standards state that "the AIMR-PPS Claim of Compliance statement can only be made on a presentation that fully adheres to the requirements of the AIMR-PPS standards." Issuance of a qualified (except for) opinion is not permitted in a verification engagement.

To avoid confusion to users of the report, the practitioner should add a paragraph to a Level I report disclaiming an opinion on the performance results of any specific composites that may accompany the report. This recognizes that the practitioner cannot control whether the Level I verification report may be distributed by the investment firm as part of an AIMR-PPS standards-compliant composite presentation that has not also had a performance examination (Level II) conducted.

Example 1: Reporting on Management's Assertions

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined the accompanying management assertions of Ellerton Asset Management (the Company) for the 10-year period ended and as of December

31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I Verification set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards)[32] and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[*Signature*]
September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example 1

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

[*Signature*]
John Q. Smith
Chief Executive Officer
Ellerton Asset Management

Example 2: Reporting Directly on the Subject Matter

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined whether Ellerton Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards)[33] on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to

[32] The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the Global Investment Performance Standards (GIPS standards); therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

[33] The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the Global Investment Performance Standards (GIPS standards); therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Ellerton Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[*Signature*]
September 1, 20Y1

11.22 The following are example reports to be issued on Level I verification and performance examination (Level II) engagements. The AIMR-PPS standards specify that conducting a Level I verification is a condition of conducting a performance examination (Level II); the examination report on the Level I verification may be issued prior to or concurrent with the performance examination report (Level II). Practitioners who conduct performance examinations (Level II) should report both on management's assertions about the subject matter of a Level I engagement and on the performance results of the specific composites that are the subject matter of the performance examination (Level II). The AIMR-PPS standards require that composite presentations that are the subject of a performance examination (Level II) report be attached to the report.

Example 1: Reporting on Management's Assertions

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying management assertions of Atlas Asset Management (the Company) for the 10-year period ended and as of December 31, 20Y0. We have also examined management's assertion relating to the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) and such other procedures we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[*Signature*]
September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example 1

Atlas Asset Management
10 Main Street
Anytown, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

We also assert that the statements of performance results for the ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented in conformity with the Association for Investment Management and Research Performance Presentation Standards.

[*Signature*]
John Q. Jones
Chief Executive Officer,
Atlas Asset Management Company

Example 2: Reporting Directly on the Subject Matter (Level I and Performance Examination (Level II) Report)

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined whether Atlas Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Research and Management Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. We have also examined the accompanying [*refer to title of accompanying statement*] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures and for the [*refer to title of accompanying statement*]. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Atlas Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

Also, in our opinion, [*refer to title of accompanying statement*] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0, is presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's XYZ Composite.

[*Signature*]
September 1, 20Y1

Example 3: Reporting Directly on the Subject Matter (Performance Examination (Level II) Report With a Reference to a Separate Report on a Level I Verification)

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying [*refer to title of accompanying statements*] of Atlas Asset Management's (the Company) ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. The Company's management is responsible for these statements. Our responsibility is to express an opinion based on our examination. We previously conducted an examination (also referred to as a Level I verification) of (1) the Company's compliance with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) whether the Company's processes and procedures were designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0; our report dated August 7, 20Y1, with respect thereto is attached.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included performing the procedures for a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, [*refer to title of accompanying statements*] of the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[*Signature*]
September 1, 20Y1

Illustrative Representation Letter—XYZ Investment Company

11.23 Following is an illustrative management representation letter. Consideration should be given to obtaining representation on additional items, including, where applicable, an investment adviser's intentions to continue waiving fees, commissions paid to broker-dealers where they are affiliated parties, and the amount and terms of unreimbursed distribution costs carried forward.

January 21, 20X5

To [*Independent Auditor*]

We are providing this letter in connection with your audit of the statement of assets and liabilities, including the schedule of investments (or statement of net assets), of XYZ Investment Company (the Company) as of December 31, 20X4, and the related statements of operations (and cash flows, if applicable), for the year then ended, changes in net assets for the two years then ended, and the financial highlights for the five years then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations (and cash flows, if applicable), changes in net assets, and financial highlights of XYZ Investment Company in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations, (cash flows, if applicable), and financial highlights in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief as of [*date of auditor's report*], the following representations made to you during your audit:

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
   c. Information relating to all statutes, laws, or regulations that have a direct effect on our financial statements.
   d. Information relating to contracts with and results of work by specialists.
3. There have been no communications from regulatory agencies, such as the Securities and Exchange Commission (SEC) or the Internal Revenue Service, concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

6. We have no knowledge of any fraud or suspected fraud affecting the entity involving —
   a. Management,
   b. Employees who have significant roles in internal control, or
   c. Others where the fraud could have a material effect on the financial statements.
7. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
8. There are no significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the Company's ability to record, process, summarize and report financial data.[34]
9. The Company has no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions and other transactions with affiliates, including fees, commissions, purchases, and sales
    b. Guarantees, whether written or oral, under which the Company is contingently liable[*]
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*]
    d. Arrangements with financial institutions involving compensating balances, or other arrangements involving restrictions on cash balances and lines of credit or similar arrangements [*Note: If this is not applicable, refer to 9 below.*]
    e. Capital stock repurchase options or agreements, or capital stock reserved for options, warrants, or other requirements (possibly applicable to closed-end companies)
    f. All financial instruments, including those with off-balance-sheet risk (such as swaps, forwards, and futures), as required under generally accepted accounting principles
    g. Each significant concentration of credit risk arising from all financial instruments whether from an individual counterparty or group of counterparties in accordance with Financial Accounting Standards

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[34] This representation was added consistent with the requirements of the Sarbanes-Oxley Act and is applicable only to audits of SEC-registered funds where certifications are required to be filed on Form N-CSR.

[*] In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions are only applicable on a prospective basis for guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002.

Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

11. There are no—
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB Statement No. 5, *Accounting for Contingencies.*[35]
    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
12. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral. All portfolio securities are marketable, except as disclosed in the financial statements.
13. The Company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
14. We also advise you that, to the best of our knowledge and belief—
    a. Portfolio securities are stated at fair value as determined in accordance with the valuation methods set forth in the current prospectus. All Company investments during the period were made in accordance with the investment policies stated in the current prospectus. [*For those funds that have significant investments stated at fair value as determined by the board of directors to address the appropriateness of the valuation methodology and fair values assigned, the following sentence should be added: "For securities whose fair values have been estimated by the Board of Directors, the valuation principles used are appropriate and have been consistently applied and the fair values are reasonable and supported by the documentation."*][36]
    b. The Company complied with the provisions of the Investment Company Act of 1940, as amended (the Act), and the rules and regulations thereunder, and with the provisions of its prospectus and the requirements of the various Blue Sky laws under which the Company operates.

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[35] In the circumstances discussed in footnote 7 of FASB Statement No. 5, *Accounting for Contingencies*, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

[36] In January 2003, the ASB issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures*. The standard contains expanded guidance on the audit procedures for fair value measurements and disclosures. Among other things, SAS No. 101 lists several representations about fair value measurements and disclosures contained in the financial statements that the auditor may consider obtaining from management. SAS No. 101 provides that depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

The daily net asset value has been properly computed throughout the year for open-end funds in accordance with rule 2a-4 of the Act (or rule 2a-7 for money market funds) and was correctly applied in the computation of daily capital stock sales and redemption transactions.[37]

c. The Company did not make any commitments during the year as underwriter, nor did it engage in any transactions made on margin, in joint trading or in a joint investment account, or in selling short.[38]

d. The Company has complied with the requirements of subchapter M of the Internal Revenue Code of 1986, as amended, through the date of this letter, and intends to continue to so comply. Additionally, the Company has properly identified all passive foreign investment companies (PFICs) that it holds.[39]

e. The Company, except to the extent indicated in its financial statements, does not own any securities of persons who are directly affiliated as defined in section 2(a)(3) of the Act.[40]

f. The Company has complied with the provisions of its code of ethics.

To the best of our knowledge and belief, no events or transactions have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

[*Name of President or Chief Executive Officer and Title*]

[*Name of Treasurer or Chief Financial Officer and Title*]

11.24 For registered investment companies that include certifications of the Principal Executive Officer and Principal Financial Officer in filings on Form N-CSR, the individuals certifying in those capacities should also sign the representation letter in order to directly confirm and document the communications to auditors described in their certifications (see paragraph 2.141). Other officers who provide material representations during the audit should also be considered for inclusion as signers.

Illustrated Updated Representation Letter—XYZ Investment Company

11.25 The following form of representation letter should be received in connection with the filing of registration statements either on Form N-1A for open-end investment companies or Form N-2 for closed-end investment companies. Such representation letters should be obtained upon filing the registration statement, as well as on the effective date of the registration statement in those situations where the filing is not immediate and is, therefore, subject to review by the SEC before being considered effective.

April 28, 20X5

To [*Independent Auditor*]

The following representations, made to the best of our knowledge and belief, apply to XYZ Investment Company (the Company) and are submitted in connection

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[37] These representations are required for SEC purposes and therefore should not be included in the representation letter for a nonpublic entity.

[38] See footnote 37.

[39] See footnote 37.

[40] See footnote 37.

with the filing with the Securities and Exchange Commission of the Company's registration statement on Form N-1A (or N-2).

1. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

2. Since [*audit date*], there have been no events or transactions, other than those events and transactions disclosed in the financial statements, that could have a material effect on the financial statements included in the registration statement or that should be disclosed in order to make those statements not misleading.

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[*Name of President or Chief Executive Officer and Title*]

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[*Name of Treasurer or Chief Financial Officer and Title*]

Chapter 12

Basis for Conclusions

Consolidation and the Equity Method

12.01 Paragraphs 7.04 and 7.05 of this Guide provide that consolidation or use of the equity method of accounting by an investment company of a non-investment company investee is not appropriate, except for an investment in an operating company that provides services to the investment company. In contrast, Accounting Research Bulletin 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*,* requires consolidation of all majority-owned subsidiaries unless control is likely to be temporary or it does not rest with the majority owner. FASB Statement No. 94's application to investment companies is unclear. Although investment companies are not specifically excluded from the scope of Statement No. 94, Statement No. 94 acknowledges in paragraph 53 the existence of specialized industry practices for investment companies. In discussing the Board's decision to remove an exposure draft requirement to use the cost method for majority-owned subsidiaries that remain unconsolidated, it states:

> . . . respondents said that the requirement would change practice because "significant influence" might remain even if control were lost and *because of specialized industry practices for investment companies*. The Board removed the requirement to use only the cost method, thereby leaving existing pronouncements in effect. The method to be used to account for those subsidiaries will be considered in the broad project described in paragraphs 19 and 20 [a project on the reporting entity, including consolidations and the equity method]. [emphasis added]

The guidance in paragraphs 7.04 and 7.05 of this Guide is consistent with long-standing industry practice. That practice results in investment company financial statements that focus on a net asset value that reflects the fair value of the underlying investments. The purpose and nature of investment companies makes fair value for their investments the most relevant measure to report to their investors, the principal users of their financial statements who typically evaluate the performance of the investment company based on changes in net asset value. Exchanges of open-end investment company shares are at, or based on, net asset value. Purchasers and sellers of other investment company (for example, closed-end investment companies) shares often consider the premium or discount based on net asset value that is present in the exchange price. Regulation S-X, rule 6-03(c)(1) also precludes consolidation by a registered investment company of any entity other than another investment company. Similarly, Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, does not apply to "investments in common stock held by investment companies registered under

* FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amended ARB No. 51 to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary.

the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly." In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* an interpretation of ARB No. 51. Until the issuance of this Interpretation, investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. FASB Interpretation No. 46 would change the model for determining when to consolidate a controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. The Interpretation would also require disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company. In August 2003, the FASB Board has directed the FASB staff to issue a FASB Staff Position delaying the effective date of FASB Interpretation No. 46 for investment companies not subject to SEC Regulation S-X, Rule 6-03(c)(1) that are currently accounting for their investments in accordance with the specialized accounting guidance in this Guide. The deferral would not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity. The FASB Board decided to delay the effective date for these parties while the AICPA finalizes its proposed SOP on the clarification of the scope of this Guide and accounting by the parent companies and equity method investors for investments in investment companies. When the AICPA issues the final SOP, the FASB Board will consider modifying paragraph 4(e) of FASB Interpretation No. 46 to provide an exception for companies that apply the Guide as revised by the SOP. Readers should be alert for additional action by the FASB and the ultimate impact FASB Interpretation No. 46 may have on non-registered investment companies. As mentioned above, AcSEC issued an Exposure Draft of a proposed Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, to clarify the scope of this Guide. The final SOP is expected to be issued in the first quarter of 2004 and may supersede or amend the consolidation guidance in this Guide. The proposed SOP would nullify the guidance in Emerging Issues Task Force (EITF) Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, but only as it applies to investment companies.

Payments by Affiliates and Corrections of Investment Restriction Violations

12.02 Paragraphs 7.49 through 7.51 of this Guide provide guidance on the accounting for payments by affiliates and corrections of investment restriction violations. At times, affiliates make payments to a fund related to investment losses for one of the following two reasons:

a. To reimburse the effect of a loss (realized or unrealized) on a portfolio investment, often caused by a situation outside the fund's, or its affiliates', direct control, such as an issuer default or a decline in fair value.

b. To make the fund whole relative to a realized loss on a portfolio investment made by the fund adviser in violation of the fund's investment restrictions. This type of transaction is in essence a payment to put the fund's shareholders in the position they would have been in had the violation not occurred.

12.03 In 1994 and 1995, the staff of the Securities and Exchange Commission's (SEC's) Division of Investment Management published its view that registrants should present the reimbursements described in paragraph 12.2(a) as capital contributions to the fund. Although the staff had informally stated its view that the payments described in paragraph 12.2(b) should also be accounted for as capital contributions, in practice such payments had often been presented in the statement of operations, which is consistent with the recognition of items such as litigation settlements and insurance recoveries.

12.04 The Accounting Standards Executive Committee (AcSEC) of the AICPA concluded that both types of payments should be accounted for within the statement of operations. AcSEC agrees with the SEC Division of Investment Management that both types of payments should be accounted for consistently, as in some cases it may be difficult to distinguish their purposes. AcSEC believes that payments made by nonshareholders of an investment company for any reason other than for capital contributions should not be presented as such.[1] AcSEC does not believe the purpose of such payments is to make a capital contribution.

12.05 AcSEC concluded that because of the underlying reasons for such payments, the inclusion of the payments in the statement of operations should not be changed if the person making the payment is also a shareholder in the fund. AcSEC was able to distinguish these payments from transactions undertaken by a company's principal shareholder for the benefit of the company (see, for example, Interpretation No. 1, "Stock Plans Established by a Principal Stockholder," of APB Opinion 25, *Accounting for Stock Issued to Employees*, and SEC Staff Accounting Bulletin No. 79, "Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)"), as arising from the person's service relationship to the fund, not its shareholder relationship. AcSEC was informed that service providers who own no shares in a fund make similar payments, and that in many cases the service providers' ownership interests arise principally to provide initial capital to the fund; over time, such interests either become *de minimis* or are redeemed. AcSEC was concerned about the resulting lack of comparability if similar payments were subject to substantially different presentation based solely on the person's shareholder status, and was unwilling to specify an ownership percentage representing a threshold above which the accounting would change. Further, AcSEC observed that the payments typically do not enhance the value of the person's equity investment in the fund beyond a pro rata interest in the payment itself, because the value of investment company shares either equals or is directly related to net asset value per share. AcSEC thus believed that the payments ordinarily are intended to maintain a person's service relationship with the fund rather than to enhance or maintain the value of the person's investment in the fund.

12.06 In considering the presentation of the payments within the statement of operations, AcSEC considered the guidance in paragraph 26 of APB

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[1] AcSEC limited its discussion to the issues addressed in paragraph 12.2. AcSEC does not intend that its conclusions be applied more broadly, either by entities not within the scope of this Guide, or for payments made for other reasons.

Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. AcSEC was informed that payments of the type specified in paragraph 12.2(a) historically have been infrequent, typically occurring when an investment-grade issuer suddenly and unexpectedly defaulted, and that transactions in violation of investment restrictions, whether resulting in gains or losses, and payments of the type described in paragraph 12.2(b), are inherently infrequent (see, for example, paragraph 2.101). AcSEC thus agreed with the recommended presentation of such items within a separate component of the statement of operations as described in paragraph 7.50. AcSEC also believes that the inconsistency between these transactions and the operating practices stated in the fund's governing documents provides further support for such presentation. Finally, AcSEC concluded that the effect of these transactions on a fund's total return should be disclosed in the financial highlights, because total return is an important measure of performance and the transactions are being held out in the statement of operations as distinct from the fund's normal activities.

Premium Amortization

12.07 This Guide requires that "premiums and discounts (on debt securities) be amortized using the interest method." The prior Guide was silent on whether funds should be required to amortize premiums and discounts on debt securities. The economic substance of an investment in a debt security is that the discount or premium paid is an adjustment of the stated interest rate to a current market rate. Amortizing premiums and discounts, as an adjustment to interest income, is consistent with the economic substance of the transaction. Many funds investing in taxable bonds currently do not amortize premiums for book or tax purposes, providing the fund with a higher dividend rate (although not a higher yield). Also, some funds amortize discounts on taxable bonds, but do not amortize premiums. (Premium amortization on tax-exempt obligations is required for tax purposes, and funds follow this practice for financial reporting purposes as well.) It appears inconsistent to amortize discounts but not amortize premiums (or to amortize both discounts and premiums in some funds but not in others) based solely on the tax elections made by a particular fund.

12.08 Mandatory amortization will affect the characterization of income shown in the statement of operations and in the financial highlights. However, this change results in no net increase or decrease in the net gain or loss from investment activities reported in the statement of operations and financial highlights (merely a reclassification between net investment income and realized or unrealized appreciation). The ratio of net investment income to average net assets in the financial highlights will be affected.

12.09 Accounting literature clearly supports recording interest income in a manner that is consistent with the economic substance of the transaction. APB Opinion No. 21, *Interest on Receivables and Payables*, paragraph 15, requires that "the difference between the present value and the face amount should be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period."

12.10 Arguments opposing mandatory amortization include—

a. Investment companies are essentially tax pass-through vehicles and therefore the tax treatment of items should affect the accounting treatment.

b. Differences between the tax and accounting treatment will create book versus tax differences that may serve to confuse the investor.

c. Treatment of these items in Statement of Position (SOP) 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*, may further confuse the investor as they may create dividends "in excess of" net investment income. (Note: This Guide does not continue that terminology.)

d. The SEC yield calculation currently takes into account the effect of premium amortization.

e. As tax regulations would not be changed, funds may be required to modify accounting systems to maintain different book and tax cost records for securities.

12.11 AcSEC considered these arguments for continuing the current practice, but it believes that amortization of premiums and discounts should be mandatory under generally accepted accounting principles (GAAP) for the reasons discussed in paragraph 12.07 and 12.09. Finally, AcSEC believes that the information provided will be more meaningful to investors.

Excess Expense Plans

12.12 Paragraph 8.05 provides new guidance on the accounting for "excess expense" plans. Some open-end investment companies, before commencing operations, enter into agreements with their advisers, or other service providers, under which the service provider agrees either to reimburse all expenses in excess of a stated percentage of average net assets or to forego current payment of a specific expense. These arrangements help new funds, with lower asset levels, maintain lower expense ratios, which results in a benefit to the shareholder. Typically, one condition attached to these arrangements is that the investment company agrees to repay the service provider (without interest) if, and to the extent that, the investment company's net assets increase sufficiently to permit such payments without exceeding the stated percentage expense limitation. Also typically, these agreements (*a*) are terminable on short notice by either party without a penalty, (*b*) have a fixed expiration date, and (*c*) give the service provider no claim against the investment company for any amounts not reimbursed upon termination or expiration. The economic result of these agreements is to defer payment of the expenses until the investment company is financially able to bear them or, upon termination or expiration, to eliminate them entirely.

12.13 In evaluating the appropriate accounting for these agreements, AcSEC considered the following:

a. The provisions of FASB Statement No. 5, *Accounting for Contingencies*, that require recognition of a loss if "it is probable that . . . a liability [has] been incurred" and "the amount of the loss can be reasonably estimated"

b. The characteristics of liabilities described in paragraphs 35 through 42 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*

c. AcSEC's conclusions in SOP 95-3, *Accounting for Certain Distribution Costs of Investment Companies,* that require recognition of a liability by investment companies entering into so-called "enhanced" distribution plans

12.14 AcSEC does not believe that SOP 95-3 should be applied to excess expense plans, because two critical features distinguish them from enhanced distribution plans:

a. Payment of any amount under an excess expense plan depends upon the fund achieving and maintaining a sufficient asset level to support repayment, an event that is dependent on future circumstances not necessarily under the control of either the fund or the service provider (for example, investor purchases of shares and market appreciation).

b. The fixed expiration date of the agreement could result in the service provider being unable to recover part or all of the amounts initially reimbursed or foregone.

12.15 AcSEC concluded that the essential criteria found in the definition of a liability in FASB Concepts Statement No. 6, paragraph 36 and in FASB Statement No. 5, paragraph 8 should be applied to excess expense plans. FASB Concepts Statement No. 6, paragraph 36 includes the following criteria: "a present duty or responsibility to one or more other entities that entails settlement by a probable future transfer or use of assets . . . " (criterion .36(a), "[a] duty or responsibility obligat[ing] . . . [the] entity, leaving it little or no discretion to avoid the future sacrifice" (criterion .36(b)), and "the transaction or other event obligating the entity has already happened (criterion .36(c)). FASB Statement No. 5, paragraph 8 includes the following criteria: "(a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. . . ." and "(b) the amount of the loss can be reasonably estimated."

12.16 AcSEC observed that, in most instances, a liability for excess expenses under such plans will not be recorded until amounts are actually due to the adviser under the reimbursement agreement because it is not likely that the criteria cited in paragraph 12.15 will be met at an earlier time. Under most excess expense plans, a fund is obligated to repay a servicer for expenses incurred previously only if, during a defined period, the fund (*a*) retains the service provider and (*b*) can reduce its expense ratio to a low enough level to permit payment, and maintain that ratio at a sufficiently low level thereafter. Many substantive conditions could cause the fund to have no obligation to the servicer, including failure to attract assets, significant redemptions of shares by investors, market depreciation, and significant increases in other expenses, all of which could drive expenses up to or beyond the maximum under which payment would otherwise be made. Even actual reimbursement of some expenses does not establish the appropriateness of accrual of additional unreimbursed amounts, as these conditions must continually be met for the fund to be further obligated to the servicer.

12.17 AcSEC noted, however, that if an assessment of the specific circumstances (such as an agreement to reimburse for either an unlimited period or a period substantially greater than that necessary for the fund to demonstrate its economic viability or an obligation to reimburse the servicer remains even after the cancellation of the fund's contract with the servicer) indicates that the criteria cited in paragraph 12.15 are met, a liability should be recorded.

Complex Capital Structures

12.18 In the last decade, new investment vehicles and capital structures such as funds of funds, master-feeder arrangements, and multiple classes of shares, have been developed and have become an increasingly significant segment of the investment companies currently in existence. Funds of funds either permit a fund complex to provide **asset allocation** products using funds in the complex, or allow an investment manager to allocate assets among many unaffiliated investment managers. Master-feeder and multiple-class structures permit a common investment vehicle to be distributed through different channels, or with different distribution charges to the shareholder, or both.

12.19 AcSEC has included a new chapter in the Guide (chapter 5) that provides information on accounting, reporting, and auditing for these new structures. The new guidance is derived primarily from SEC positions as stated in exemptive orders, SEC generic comment letters, prevailing practice as documented in industry association white papers, SEC no-action letters, and, for multiple-class share structures, rule 18f-3 of the Investment Company Act of 1940 (the 1940 Act).

Schedule of Investments

12.20 The prior Guide required investment companies to disclose a complete listing of investments in a manner consistent with the SEC's disclosure requirements of Regulation S-X. This Guide defines the reporting requirements for two groups of investment companies: investment companies (paragraph 7.11) and nonpublic investment partnerships* (paragraph 7.12).

12.21 Nonpublic investment partnerships** (including hedge funds, limited liability companies, limited liability partnerships, limited duration companies, offshore investment companies with similar characteristics, and commodity pools subject to regulation under the Commodity Exchange Act of 1974) are required to follow the reporting requirements of SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools.*) This Guide requires registered and nonregistered investment companies (for example, common [collective] trust funds) to disclose the following in the absence of regulatory requirements (paragraph 7.10):

a. Each investment (including short sales, written options, futures, forwards, and other investment-related liabilities) whose fair value constitutes more than 1 percent of the fund's net assets

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* In July 2003, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The exposure draft provides guidance on the application of certain provisions of this Guide and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. The proposed SOP would amend certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the proposed SOP would incorporate and elevate in authority the guidance provided in previously issued *Technical Practice Aids* (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs would be revised as a result of further deliberations while the guidance in other TPAs would be carried forward without change.

A final pronouncement is expected to be issued in the fourth quarter of 2003. A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis would be permitted, but not required. If adopted, the provisions of the SOP would be applied prospectively from the beginning of the year of adoption. Readers should be alert to any final pronouncement.

** See footnote * above.

b. All investments in any one issuer whose fair values aggregate more than 1 percent of the fund's net assets

c. At a minimum, the fifty largest investments

In applying the 1-percent test, total long and total short positions in any one issuer are to be considered separately.

12.22 This Guide also requires the organization of all investments that meet the disclosure criteria by type, industry, geographic concentrations, or all three concentrations. Investments below these disclosure thresholds would be categorized and included within each of these criteria as "other" investments. In addition to the required categorizations, in the absence of regulatory requirements, investment companies are also required to report any other significant areas of concentration in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

12.23 FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 40, states, "the benefits of information may be increased by making it more understandable and, hence, useful to a wider circle of users." Meaningful information is not measured solely by volume; content and materiality also affect the quality of the information presented. Focusing investors on material items within the financial statements provides more understandable and useful information without burdening investors with unnecessary details.

12.24 Disclosures about current portfolios include each security position and are often voluminous. Each holding is given equal prominence in the schedule of investments. Individual securities that represent less than 1 percent of a fund's portfolio have limited effect on investment performance. Larger positions are more significant to shareholders, particularly when classified by type and industry or geography. Current events surrounding an industry, a significant investment holding, or geographic concentration are more likely to affect a fund's investment performance. Summarized portfolio presentation will enable investors to make decisions focusing on the risks and opportunities associated with the type of investment and geographic area or industry by investment.

12.25 The presentation of investment company financial statements in conformity with GAAP should include a schedule (or condensed schedule) of investments. AcSEC believes that the schedule of investments is as important to investment company financial statements as is the statement of assets and liabilities, statement of operations, statement of changes in net assets, and the financial highlights.

Organization and Offering Costs

Organization Costs

12.26 This Guide (paragraphs 8.17 through 8.23) provides guidance as to the appropriate accounting for organization costs incurred during the development stage of an investment company. Prior to the adoption of SOP 98-5, *Reporting on the Costs of Start-Up Activities,* investment companies capitalized organization costs and amortized them over the period of future benefit, usually sixty months. This Guide incorporates the requirements of SOP 98-5 to expense organization costs as incurred.

Offering Costs

12.27 This Guide (paragraph 8.24) provides new guidance on the accounting for offering costs. The following wording has been added to the Guide: "Offering costs of closed-end funds and investment partnerships should be charged to paid-in capital upon sale of the shares or units. Offering costs of open-end investment companies and of closed-end funds with a continuous offering period should be accounted for as a deferred charge until operations begin and thereafter amortized to expense over twelve months on a straight-line basis."

12.28 Closed-end funds and investment partnerships charge these costs directly against capital (that is, net assets) upon the sale of the shares or units. This results in such costs being borne by the initial shareholders of the closed-end fund or partnership. Open-end investment companies are in the business of issuing and redeeming their shares continuously. As a result, offering costs are capitalized as a prepaid expense and amortized over a twelve-month period. The Guide does not change prevailing industry practice for such funds.

12.29 Unit investment trusts (UITs) have characteristics that are similar to both open-end and closed-end investment companies. Some UITs offer shares only at a particular time, while others provide for ongoing sales over a longer offering period. AcSEC recognized that requiring a UIT to charge its offering costs to paid-in capital at the commencement of its offering or immediately after its units or shares are sold to the underwriters would require the underwriters, and not the shareholders, to bear those costs. AcSEC concluded that those offering costs should be deferred and charged to paid-in capital on a pro rata basis as the sale of those units by the UIT occurs (that is, in proportion to the shares sold relative to the total number of shares authorized for sale). This method serves to match those costs with the proceeds received from the sale of the units or shares. AcSEC also expressed concerns about deferring those costs indefinitely, and therefore concluded that a presumption exists that those costs will not have a future benefit one year from the initial offering. Consequently, offering costs that remain unamortized at the end of one year should be reviewed for impairment. AcSEC also considered whether these offering costs should be deferred until those units or shares are sold by the underwriters to the public. AcSEC concluded that the capital-raising effort of the UIT was completed upon the sale of the units or shares to the underwriters and therefore support for further deferral did not exist.

12.30 Other kinds of offering costs, such as front-end sales charges and deferred sales charges, are deducted from the proceeds received from shareholders or redemption proceeds paid to shareholders, are not paid by the fund, and therefore are outside the scope of offering costs as defined herein.

Changes to SOP 93-2

12.31 This Guide incorporates and makes changes to SOP 93-2. A registered investment company is defined herein as an investment company registered with the SEC under the 1940 Act. SOP 93-2 was issued to provide guidance on disclosure of information to shareholders of registered investment companies concerning the character of dividends received from the investment company. Specifically, it provided more uniformity in the reporting for dividends that shareholders receive for financial statement and federal income tax purposes. SOP 93-2 required that dividends paid that are greater than book income, but not a tax return of capital, be called "dividends in excess" of book income. It also required separate disclosure of dividends that are a tax return of capital.

12.32 Registered investment companies are required by Regulation S-X (rule 6-04) to disclose, on the balance sheet, the following components of capital:

a. Shareholder capital (that is, common stock and paid-in capital)

b. Undistributed net investment income

c. Undistributed net realized gains

d. Unrealized appreciation (depreciation)

12.33 For federal income tax purposes, registered investment companies declare dividends from the following three categories:

a. Ordinary income (net investment income plus short-term capital gains)

b. Capital gains (net long-term capital gains)

c. Tax return of capital

12.34 As the dividend declarations do not correspond exactly with the components of capital for book accounting purposes, issues frequently arise in the manner in which the dividends should be charged to the capital components. This difficulty is compounded by the many temporary and permanent book-tax differences that arise.

12.35 SOP 93-2 was difficult for industry practitioners to apply. Also, because of the unique nature of the caption "dividends in excess," shareholders' understanding of such distributions has not been enhanced, as originally contemplated by the SOP. Until SEC requirements are modified, however, the requirements of SEC Regulation S-X to disclose individual components of distributable earnings (undistributed income, accumulated gains (losses), and unrealized appreciation (depreciation)) and distributions (income, gain, and return of capital) continue to apply for SEC registrants, and preparers should continue to apply the basic principles of SOP 93-2 in accumulating the required information.

12.36 The Guide now requires all investment companies to disclose only two components of capital on the balance sheet: shareholder capital and distributable earnings. The components of distributable earnings, on a tax basis, should be disclosed in a note to the financial statements. This information enables investors to determine the amount of accumulated and undistributed earnings they potentially could receive in the future and on which they could be taxed.

12.37 The Guide also requires that dividends paid be disclosed as a single line item in the statement of changes in net assets, except tax return of capital distributions, which should be disclosed separately. The notes should disclose the tax basis components of the dividends paid (that is, either from ordinary income, capital gains, or tax return of capital). Disclosing dividends on a tax basis is consistent with how dividends are reported to shareholders during and at the end of the calendar year. The financial highlights table would disclose per share information that is consistent with the statement of changes in net assets.

12.38 AcSEC believes that these changes will allow preparers of financial statements to account for and disclose information in a more efficient manner. Also, users of such information would be provided with less complex terminology and a basis of disclosure that is more consistent with the information they receive for federal income tax purposes. The Guide is not adopting tax basis accounting; it merely provides disclosure of dividends paid and distributable earnings on a tax basis.

Appendix A

Venture Capital and Small Business Investment Companies

Venture capital investment companies, including most small business investment companies (SBICs), and business development companies differ in operating method from other types of investment companies. The usual open-end or closed-end company is a passive investor, whereas the venture capital investment company is more actively involved with its investees. In addition to providing funds, whether in the form of loans or equity, the venture capital investment company often provides technical and management assistance to its investees as needed and requested.

The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are usually securities with no public market. Often, gains on those investments are realized over a relatively long holding period. The nature of the investments therefore requires valuation procedures that differ markedly from those used by the typical investment company with which this Guide primarily deals.

Venture capital investment companies may incur liabilities not generally found in other investment companies. **Leverage** opportunities available to the owners of those companies are not available to open-end companies and are not often found in closed-end companies. SBICs, by statute, may borrow from the Small Business Administration (SBA), often at advantageous rates, up to two or three times their paid-in capital.

Although all venture capital investment companies should prepare their financial statements in conformity with generally accepted accounting principles and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors. For example, if debt is a significant item, a balance sheet might be more appropriate than a statement of net assets. Also, different regulatory procedures may apply. Publicly owned SBICs are subject to the provisions of article 5 of Regulation S-X, whereas other publicly owned venture capital investment companies are subject to article 6.

The unique features (primarily the existence of significant debt) of SBICs often make it desirable that their financial statements be presented in a conventional balance sheet format. SBICs are regulated by the SBA and accordingly are required to comply with part 107 of the SBA rules and regulations. Appendixes I and II of part 107 deal with specific aspects of SBA regulation, such as the specific audit procedures and reporting requirements (for example, on Form 468) of the SBA for SBICs, the system of account classification, and guidance on proper techniques and standards to be followed in valuing portfolios. The auditor of an SBIC should be familiar with those publications and aware of changes in SBA regulations.

The format for reporting the results of SBIC operations varies from that presented in this Guide for other types of investment companies.

Appendix B

Computation of Tax Amortization of Original Issue Discount, Market Discount, and Premium

Table 1

Amortization of Original Issue Discount (OID)

		Reporting of Amortization		Characterization of Amortization	
	Method of Amortization	*On a Daily Basis*	*At Disposition*	*Capital Gain*	*Interest Income*
Taxable obligations:					
Short-term corporate obligations[1]	SL[2]	X			X
Long-term corporate obligations					
Issued before 5/28/69	SL		X		X
Issued 5/28/69–7/1/82	SL	X			X
Issued after 7/1/82	YTM	X[3]			X
Short-term government obligations[1]	SL[2]	X			X
Long-term government obligations					
Issued before 7/2/82	SL		X		X
Issued after 7/1/82	YTM	X[3]			X
Tax-exempt obligations:					
Short-term obligations[1]	SL[2]	X			X[4]
Long-term obligations					
Issued prior to 9/4/82 *and* acquired prior to 3/2/84	SL	X			X[4]
All other acquisitions	YTM	X			X[4]

SL = Straight-line (ratable); YTM = yield to maturity.

[1] Short-term is defined as having a maturity of not more than one year after the date of issue.

[2] An election may be made to use the yield-to-maturity method.

[3] Accrual period with respect to which OID is computed and compounded is a one-year period for obligations issued before 1/1/85 and is a six-month period for obligations issued after 12/31/84.

[4] Amortization is characterized as tax-exempt interest.

Table 2

Amortization of Market Discount

		Reporting of Amortization		Characterization of Amortization	
	Method of Amortization	*On a Daily Basis*	*At Disposition*	*Capital Gain*	*Interest Income*
Taxable obligations:					
Short-term obligations[1]					
Government obligations	SL[2]	X			X
Corporate obligations	YTM[3]	X			X
Long-term obligations					
Issued after 7/18/84	SL[2]	[4]	X		X[5]
Issued before 7/19/84	N/A		X	X	
Tax-exempt obligations:					
Acquired on or before 4/30/93					
Long-term	N/A				
Short-term	N/A				
Acquired after 4/30/93					
Long-term	SL[2]	[4]	X		X
Short-term	N/A				

SL = Straight-line (ratable); YTM = yield to maturity; N/A = not applicable.

[1] Short-term is defined as having a maturity of not more than one year after the date of issue.

[2] An election may be made to use the yield-to-maturity method.

[3] An election may be made to use the straight-line method.

[4] An election may be made to report amortization currently as interest. The election would apply to all market discount bonds acquired on or after the first day of the taxable year in which the election is made.

[5] Amortization of accrued discount is treated as interest income to the extent of the realized gain on disposition.

Table 3

Amortization of Premium

	Method of Amortization	Reporting of Amortization: On a Daily Basis	Reporting of Amortization: At Disposition	Characterization of Amortization: Non-deductible Expense	Characterization of Amortization: Offset to Interest Income
Taxable obligations:					
Obligations issued after 9/27/85					
If election is made to amortize	YTM	[1]			
If no election is made to amortize	N/A[5]				
Obligations issued before 9/28/85	[3]	[1]	X		X[2]
Tax-exempt obligations:					
Obligations issued after 9/27/85	YTM[4]	X			X
Obligations issued before 9/28/85	[3]	X		X	

YTM = yield to maturity; N/A = not applicable, no amortization needed.

[1] An election is made to report amortization currently. Such will apply to all bonds held by the taxpayer at the beginning of the taxable year and to all bonds thereafter acquired by the taxpayer.

[2] For bonds acquired between 10/23/86 and 1/1/88, premium amortization is treated as interest expense.

[3] Any reasonable method of amortization may be used.

[4] The amortization should be computed taking into account call dates and call prices.

[5] Premium is part of tax basis of security and affects tax gain or loss on disposition or maturity of the obligation.

Appendix C

Internal Revenue Code Worksheets

I. Internal Revenue Code (IRC) section 851 requirements:

Assets (as of close of each quarter):[1]

A	Cash, receivables, securities, and total other assets (total assets)		$ ______
B-1	Cash, receivables, government securities, and securities of other regulated investment companies (RICs)	$ ______	
B-2	Other securities not including either (a) securities of any one issuer having a value in excess of 5 percent of line A or (b) securities representing more than 10 percent of the outstanding voting securities of any one issuer. (Exclude entire amount of investments that exceed either limitation.)	$ ______	
B-3	(Lines B-1 plus B-2) Line B-3 must be at least 50 percent of line A		$ ______
C	25 percent of line A		$ ______

No one issue (other than government securities or securities of other RICs) can exceed line C.

Income (for the taxable year to date):[2]

1.	Gross gains (tax basis, excluding all losses) on:	
	a. Stock or securities sold	$ ______
	b. Options, futures, and forwards	______
	c. Foreign currencies	______
2.	Interest and dividends from investments	______
3.	Income from securities on loan	______
4.	Other Income	______
D	Total (sum of lines 1 through 4)	$ ______
E	10 percent of line D	$ ______

[1] Pursuant to section 851(d), a RIC that would be deemed not to meet the diversification requirements of section 851(b)(3), as applied at the close of any quarter, nevertheless shall be considered to have met such requirements if the discrepancy otherwise causing such failure is corrected within thirty days after the end of such quarter.

[2] This computation should be done by the RIC at least monthly so that failure to meet the requirements can be determined and corrected on a current basis.

Other income not derived with respect to the fund's business of investing in stock, securities or currencies cannot exceed line E. (Note that the secretary may by regulations exclude from qualifying income foreign currency gains that are not directly related to the RIC's principal business of investing in stock or securities [or options and futures with respect to stock or securities]).

II. Eligibility of company's ordinary income dividends for the 70 percent dividend-received deduction for corporations:

A.	Net income[3]	$ ________
B.	Qualifying dividends[4]	$ ________
C.	Line B divided by line A	________%

The company must advise corporate shareholders of the portion of its distributions that are eligible for the 70 percent dividend-received deduction. Line C should reflect the correct percentage.

III. Test of dividend-paid deduction and federal income tax status (year ended):

Ordinary Income

1.	Net income (exclusive of equalization) Adjustments—	________
2.	Non-taxable cash dividends received	(________)
3.	Reclassification of foreign currency gain or loss	(________)
4.	Other	(________)
5.	Total	________
	Add—	
6.	Net short-term capital gains in excess of net long-term capital losses	________
7.	Net investment (taxable) income	________
	Deduct— Dividend payments in—	
8.	Current year, total	________
9.	Current year, related back to prior year	(________)
10.	Subsequent year, to be related back to current year (IRC section 855(a))	________
11.	January of subsequent year, to be related back to current year (IRC section 852(b)(7)) for calendar year funds only	________
12.	Gross equalization debits (optional)	________
13.	Total	________
14.	Subchapter M net income (loss) (item 7 less item 13)	________

[3] Investment income less expenses plus excess of net short-term capital gains over net long-term capital losses.

[4] Qualifying dividends do not include dividends received from foreign corporations, real estate investment trusts, or dividends on stock held less than forty-six days. **See paragraph 6.22.**

15.	10% of net investment income (item 7)	________
16.	Excess of 14 over 15 (excess means a disqualification)	________

Security Profits (or Losses)-tax basis

17.	Net long-term gain (loss)	________
18.	Net short-term gain (loss)	________
19.	Cash dividends treated as gains	________
20.	Reclassification of foreign currency gain or loss	________
21.	Deferral of current year post-October losses deferred	(________)
22.	Reversal of prior year post-October losses deferred	________
23.	Other	________
24.	Total	________
	Deduct—	
25.	Carryforward loss of fund	________
26.	Carryforward loss acquired by merger (subject to limitations)	________
27.	Total	________
28.	Net gain (loss)	________
	Deduct— Distributions paid in—	
29.	Current year, total	________
30.	Current year, related back to prior year	(________)
31.	Subsequent year, to be related back to current year (IRC section 855(a))	________
32.	January of subsequent year, to be related back to current year (IRC section 852(b)(7)) for calendar year funds only	________
33.	Net short-term gains included in ordinary income	________
34.	Total	________
35.	Remainder of taxable gains	________

Appendix D

Worksheet for Diversified Management Investment Companies (as defined in section 5(b)(1) of the Investment Company Act of 1940)

A. Definitions and requirements (references are to the Investment Company Act of 1940 [the 1940 Act] and rules thereunder):

1. Diversified company—A management investment company is diversified if at least 75 percent of the value of the company's total assets is represented by all of the following:

   a. Cash and cash items (including receivables)

   b. U.S. government securities

   c. Securities of other investment companies

   d. Other securities limited for any one issuer to not more than 5 percent of the value of the company's total assets and to not more than 10 percent of the outstanding voting securities of such issuer (section 5(b)).[1] (Exclude the entire amounts of investments that exceed either limitation.)

   A company does not lose its classification as diversified if the percentage requirements are not met solely because of postacquisition changes in security prices (section 5(c)).

   The portfolio requirements apply only to 75 percent of the value of the company's total assets. The remaining 25 percent need not be diversified and may be invested in the securities of a single issuer.

2. Value, as used in section 5—

   a. With respect to securities owned at the end of the preceding fiscal quarter, is the fair value at the end of such quarter.

   b. With respect to securities and other assets acquired after the end of the preceding fiscal quarter, is the cost thereof (section 2(a)(41)).

3. Total assets as used in section 5 shall mean the gross assets of the company with respect to which the computation is made, taken as of the end of the company's fiscal quarter preceding the date of computation (rule 5b-1).

B. Determine those portfolio securities that exceed 5 percent of the value of total assets at the end of each fiscal quarter.

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[1] For Internal Revenue Code purposes, the diversification worksheet is contained in appendix C. Note that special consideration should be given to the designation of the issues for investments in options, futures, and securities guaranteed by parties other than the named issuer or backed by letters of credit.

	Quarter			
	1st	*2nd*	*3rd*	*4th*
1. Total Assets	$	$	$	$
2. 5 percent of total assets	$	$	$	$

3. Portfolio securities at value in excess of line 2 above:

	Quarter-End Value			
	1st	*2nd*	*3rd*	*4th*
Security name	$	$	$	$

C. If any of the securities named in line 3 above were purchased during the quarter under review, it must be determined if that acquisition caused an investment of more than 5 percent of the company's total assets as follows:

1. Determine the total assets at the acquisition date by reference to total assets at quarter end prior to the acquisition date of the security.
2. Determine the value and percent of total assets of security acquired:
   a. Value of security at prior quarter end
   b. Add purchases of security at cost including latest acquisition
   c. Deduct sales of security at prior quarter-end value
   d. Value of security acquired (line 2a plus line 2b less line 2c)
   e. Percent of value of security acquired to total assets (line 2d divided by line 1)

D. Determination of issuers in which more than 10 percent of outstanding voting securities is owned:

1. Determine if the company owns more than 10 percent of any issuer's outstanding voting securities by referencing to current published material or other sources; include conversion of securities convertible into voting securities.
2. Determine the percentage of value of company total assets invested in such issuers at each quarter-end.

E. Total the percentages for each security acquired that exceeds 5 percent as computed in line C(2)(e) or for each security in which the company's investment constitutes more than 10 percent of the issuer's outstanding voting securities as computed in D-2 above. Total the percentages. If the sum is 25 percent or less, the company meets the requirements of a diversified company under section 5(b) of the 1940 Act. If the total is more than 25 percent at any time, no further investments may be made in the securities constituting the 25 percent nor in other issues if that investment would amount to more than 5 percent of the value of the total assets or more than 10 percent of the outstanding voting securities of the issuer.[2]

[2] Securities and Exchange Commission (SEC) staff interpretations permit testing of compliance with investment restrictions based on valuations determined as of the time of each proposed transaction. In determining the total value of assets at the time, it is sufficient to use the computation as of the close of the preceding day, with some allowance for large market price changes and sales and redemptions of shares during the day.

Appendix E

Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies

The following financial statements and disclosures illustrate a tax-free business combination of an investment company (discussed in chapter 8). The illustrative notes are unique to a business combination. The exhibits assume that Fund B merges into Fund A as of the close of business on December 31, 20X4. Exhibit 1 presents the financial position, results of operations, and changes in net assets of each fund immediately before the acquisition. Exhibits 2 and 3 present the financial statements and appropriate notes of the combined entity immediately after the acquisition, joining net assets and historical costs of investments in securities. The individual components of net assets (capital paid-in, undistributed income and capital gains, and unrealized appreciation and depreciation) are similarly combined. The results of operations, changes in net assets, and the financial highlights (not illustrated) are not restated.

Exhibit 1

Financial Position, Results of Operations, and Changes in Net Assets of Each Fund Immediately Before Acquisition

Statement of Net Assets
December 31, 20X4

	Fund A	*Fund B*
Investments in securities, at value (Cost: Fund A—$18,000,000 Fund B—$9,000,000)	$20,000,000	$10,000,000
Other assets	1,000,000	500,000
	21,000,000	10,500,000
Liabilities	1,000,000	500,000
Net assets	$20,000,000	$10,000,000
Shares outstanding	2,000,000	1,000,000
Net asset value per share	$ 10.00	$ 10.00

Exhibit 1 (continued)

Statement of Operations
Year Ended December 31, 20X4

	Fund A	*Fund B*
Dividend and interest income	$3,200,000	$1,600,000
Management fee	100,000	50,000
Transfer agent's fee	50,000	25,000
Other expenses	50,000	25,000
	200,000	100,000
Investment income—net	3,000,000	1,500,000
Realized and unrealized gain on investments		
Net realized gain from investments	1,000,000	500,000
Change in unrealized appreciation for the year	1,000,000	500,000
Net gain on investments	2,000,000	1,000,000
Net increase in net assets resulting from operations	$5,000,000	$2,500,000

Statement of Changes in Net Assets
Year Ended December 31, 20X4

	Fund A	*Fund B*
Increase (decrease) in net assets		
Operations		
Investment income—net	$ 3,000,000	$ 1,500,000
Net realized gain from investments	1,000,000	500,000
Change in unrealized appreciation	1,000,000	500,000
	5,000,000	2,500,000
Dividends to shareholders from—		
Investment income—net	(3,000,000)	(1,500,000)
Net realized gain from investments	(1,000,000)	(500,000)
Capital shares transactions	2,000,000	250,000
Total increase	3,000,000	750,000
Net assets		
Beginning of year	17,000,000	9,250,000
End of year	$20,000,000	$10,000,000

Exhibit 2

Financial Statements of the Combined Entity Immediately After Acquisition

Statement of Net Assets
December 31, 20X4

Investments in securities, at value	
Identified cost—$27,000,000	$30,000,000
Other assets	1,500,000
	31,500,000
Liabilities	1,500,000
Net assets	$30,000,000
Shares outstanding	3,000,000
Net asset value per share	$ 10.00

Statement of Operations
Year Ended December 31, 20X4

Dividend and interest income		$3,200,000
Management fee	$ 100,000	
Transfer agent's fee	50,000	
Other expenses	50,000	
		200,000
Investment income—net		3,000,000
Realized and unrealized gain on investments		
Net realized gain from investments	1,000,000	
Change in unrealized appreciation for the year	1,000,000	
Net gain on investments		2,000,000
Net increase in net assets resulting from operations		$5,000,000

Exhibit 2 (continued)

Statement of Changes in Net Assets
Year Ended December 31, 20X4

	20X4	*20X3*
Increase (decrease) in net assets—		
Operations		
Investment income—net	$ 3,000,000	$ 2,400,000
Net realized gain from investment	1,000,000	700,000
Change in unrealized appreciation	1,000,000	300,000
	5,000,000	3,400,000
Dividends to shareholders from—		
Investment income—net	(3,000,000)	(2,400,000)
Net realized gain from investments	(1,000,000)	(700,000)
Capital share transactions (Notes 6 and 7)	12,000,000	1,100,000
Total increase	13,000,000	1,400,000
Net assets		
Beginning of year	17,000,000	15,600,000
End of year	$30,000,000	$17,000,000

Exhibit 3

Notes to Financial Statements of the Combined Entity Immediately After Acquisition

Note 6—Acquisition of Fund B

On December 31, 20X4, Fund A acquired all the net assets of Fund B pursuant to a plan of reorganization approved by Fund B shareholders on December 26, 20X4. The acquisition was accomplished by a tax-free exchange of 1,000,000 shares of Fund A (valued at $10 million) for the 1,000,000 shares of Fund B outstanding on December 31, 20X4. Fund B's net assets at that date ($10 million), including $1 million of unrealized appreciation,[1] were combined with those of Fund A. The aggregate net assets of Funds A and B immediately before the acquisition were $20,000,000 and $10,000,000, respectively.[2]

Note 7—Capital Share Transactions

As of December 31, 20X4, there were 100 million shares of $1 par value capital stock authorized. Transactions in capital stock were as follows:

	Shares		*Amount*	
	20X4	*20X3*	*20X4*	*20X3*
Shares sold	500,000	300,000	$ 4,800,000	$3,000,000
Shares issued in connection with acquisition of Fund B	1,000,000		10,000,000	
Shares issued in reinvestment of dividends	300,000	250,000	3,000,000	2,400,000
	1,800,000	550,000	17,800,000	5,400,000
Shares redeemed	600,000	450,000	5,800,000	4,300,000
Net increase	1,200,000	100,000	$12,000,000	$1,100,000

[1] If appropriate, significant amounts of undistributed income and undistributed realized net gains or losses from investment transactions should be similarly disclosed.

[2] If the acquisition is completed at other than the fiscal-year end, disclosure of the combined net assets immediately after the acquisition is appropriate.

Appendix F

Illustrations for Separately Calculating and Disclosing the Foreign Currency Element of Realized and Unrealized Gains and Losses

Illustrations A and B apply if separate disclosures of the foreign currency (FC) elements of unrealized and realized gains and losses on investments are chosen by the reporting entity.

A. Purchases and Sales

ABC Fund uses US$ as its functional currency.

ABC buys 1,000 shares of XYZ @ £15.00 with a spot exchange rate of $1.75 = £1.00.

Foreign currency (FC) cost basis = £15.00 × 1,000 = £15,000

Functional currency cost basis = £15,000 × 1.75 = $26,250

Market gain/loss = (FC sale proceeds – FC cost) × foreign exchange (FX) rate on day of sale

Currency gain/loss = FC cost × (FX rate day of sale – FX rate day of purchase)

Assume a sale of 1,000 XYZ @ £12.00 and $1.50 = £1.00:

FC proceeds	= £12.00 × 1,000	=	£	12,000
Functional currency proceeds	= £12,000 × 1.50	=	$	18,000
Market loss	= (£12,000 – £15,000) × 1.50	=	$	(4,500)
Currency loss	= (£15,000 × 1.50 – 1.75)	=	$	(3,750)
Total loss			$	(8,250)

Proof

Functional currency proceeds	$	18,000
Functional currency cost	$	(26,250)
	$	(8,250)

B. Securities—Mark to Market

Day 1: *1,000 XYZ marked to market @ £16.00; spot rate: $1.85 = £1.00.*

Market gain/loss = (FC current market value – FC cost) × current FX rate

Currency gain/loss = FC cost × (current FX rate – FX rate on day of purchase)

Market gain	= (£16,000 – £15,000) × 1.85	= $1,850
Currency gain	= £15,000 × (1.85 – 1.75)	= $1,500
Total gain in functional currency		$3,350

Total gain – (£16,000 × 1.85) – (£15,000 × 1.75) = $29,600 – $26,250 = $3,350

Mark-to-Market Journal Entries

[*Average rates may be used if fluctuations in exchange rates aren't significant*]

Day 2: *1,000 XYZ marked to market @ £17.00; spot rate: $1.80 = £1.00.*

Market gain	= (£17,000 – £15,000) × 1.80 =	$3,600
Currency gain	= £15,000 × (1.80 – 1.75) =	$ 750
Total functional currency gain		$4,350

Daily Journal Entries

Market gain/loss	= $3,600 – $1,850 =	$1,750
Currency gain/loss	= $750 – $1,500 =	$ (750)
Day 2 gain ($4,350 – $3,350)	=	$1,000

C. Other Assets/Liabilities—FX Mark to Market

Sale of 1,000 XYZ @ £12.00 = £12,000 receivable @ $1.50 = £1.00 = $18,000

Day 1: *Spot rate moves to $1.55 = £1.00.*

Currency gain = £12,000 × (1.55 – 1.50).05 = $600

Day 2: *Spot rate moves to $1.58 = £1.00.*

Currency gain = £12,000 × (1.58 – 1.50).08 = $960

Currency gain	*Day 1*	*Day 2*
Daily Journal Entry	$600	$360

D. Changes Between Trade and Settlement Dates

Trade Date

Purchase 1,000 XYZ @ £15.00; exchange rate: $1.75 = £1.00.

Cost basis:	$26,250 or £15,000	
DR: sterling securities at cost	$26,250	
CR: payables for securities purchased		$26,250

Settlement Date

Spot rate: $1.80 = £1.00; £15,000 is purchased at the spot rate for $27,000.

DR: payables for securities purchased	$26,250	
DR: realized currency gain/loss	$ 750	
CR: cash		$27,000

E. Settlement Against Foreign Currency Cash Balances

£20,000 balance is available in London.

Lot a: £10,000 purchased @ $1.65 per £1.00
$US cost basis: $16,500

Lot b: £10,000 purchased @ $1.85 per £1.00
$US cost basis: $18,500

Assume lot b will be liquidated first at $1.80 per £1.00.

Lot b:

DR: cash	$18,000	
DR: realized currency gain/loss	$ 500	
CR: sterling cash at cost		$18,500

Assume one half of lot a will be liquidated at $1.80 per £1.00.

Lot a:

DR: cash	$9,000	
CR: sterling cash at cost		$8,250
CR: realized currency gain/loss		$ 750

Realized FX gain on payable remains the same.

Between Purchase Settlement and Sale Trade Dates

Mark the holding to market, based on both local market price and daily spot rate.

F. Sale of XYZ—Trade Date

Sell 1,000 XYZ @ £18.00; exchange rate: $1.90 = £1.00

Total proceeds: $34,200 or £18,000

FX gain is recognized on the sale trade date based on the holding period.

Receivable is booked at the spot rate on sale trade date.

DR: receivable for securities sold	$34,200	
CR: sterling securities at cost (£15,000 × 0£1.75)		= $26,250
CR: realized market gain/loss (£18,000 – £15,000)		= $ 5,700*
CR: realized currency gain/loss (15,000 × 1.90) – 26,250		= $ 2,250*

Maintain local currency basis (£18,000) on the receivable record.

Between Sale Trade Date and Settlement Date

Mark the receivable to market based on the prevailing spot rate.

Sale Settlement Date

Spot rate: $1.85 = £1.00

£18,000 is converted at the spot rate to $33,300.

FX loss is recognized upon the receipt (settlement) of the receivable.

DR: cash	$33,300	
DR: realized currency gain/loss	$ 900	
CR: receivables from securities sold		$34,200

If foreign currency cash received is to be kept as local currency:

Purchase: £18,000 @ $1.85 = £1.00
Cost basis: $33,300

DR: sterling cash at cost	$33,300	
CR: cash		$33,300

* If separate disclosures of the FC elements of unrealized and realized gains and losses on investments are chosen by the entity.

Appendix G

Schedule of Changes Made to Audits of Investment Companies

As of May 2003

Beginning May 2001, all schedules of changes reflect only current year activity to improve clarity.

Reference	Change
Preface (footnotes * and **)	Added to alert readers about the open SEC project on revision of annual report portfolio presentation and about the issuance of an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships.
Preface and Introduction	Revised to add "funds of funds" to the list of illustrative financial statements presented in the Guide.
Chapter 1 (title), paragraphs 1.01, 1.02, and 1.03	Footnotes * and ** added to alert readers about the issuance of an exposure draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, and that it potentially may supersede certain paragraphs within the Guide.
Paragraph 1.05 (footnote 4)	Revised to update the status of AcSEC's project to clarify the scope of the Guide.
Paragraph 1.15	Revised to reflect that the SEC changed its rules a couple of years ago to allow registered funds only offered to "qualified purchasers" to charge almost any type of incentive fee.
Paragraph 1.24	Items *e* (and footnote *) and *f* added to alert readers about the adoption of new forms N-CSR and N-PX and proposed adoption of Form N-Q; Subsequent items relettered; Item *l* added (subsequent items further relettered), and relettered item *m* revised (and footnote 12 deleted) to alert readers that Form N-6 replaced the previous combined use of Forms N-8B-2 and S-6 for insurance company separate accounts that are registered as unit investment trusts and that offer variable life insurance policies; Subsequent footnotes renumbered.
Paragraph 2.10 (footnote 9)	Revised to alert readers that Rule 17f-4 was amended.

Reference	Change
Paragraph 2.30 (footnote 20)	Revised to update the status of project on the use of a blockage factor.
Paragraph 2.64	Deleted footnote * about an exposure draft that would amend FASB Statement No. 133; Listed FASB Statement No. 149 among the FASB Statements amending FASB Statement No. 133; Added footnote * to alert readers about FASB Statement No. 149's issuance and effective date; Revised sentence about DIG to indicate that this group is officially out of existence although the FASB staff does still issue an occasional DIG issue.
Paragraph 2.97	Last sentence added to alert readers about the requirement of Rule 17f-7.
Paragraphs 2.98–2.136 and footnotes 33 and 34	Added to include a new section on fraud (industry-specific information is highlighted in grey); Subsequent paragraphs and footnotes renumbered.
Renumbered paragraph 2.137	Revised to alert readers about the issuance of SAS No. 101.
Paragraph 2.141	Added to alert readers about additional disclosures related to internal controls that are required to be made by the Sarbanes-Oxley Act; Subsequent paragraphs further renumbered.
Former paragraphs 2.102 (and footnote *) and 2.103	Deleted; These paragraphs will be replaced with a new section on fraud specifically tailored for investment companies; Subsequent paragraphs further renumbered.
Renumbered paragraph 2.146 (renumbered footnote 37)	Revised to alert readers about the issuance of SAS No. 98 which, among other things, amends SAS No. 70.
Renumbered paragraphs 2.162 (footnote 45) and 2.164 (footnote 46)	Added to alert readers about the issuance of SAS No. 101; Subsequent footnotes further renumbered.
Renumbered paragraph 2.167 (footnote 47)	Added to alert readers that they also need to consider guidance provided in SAS No. 101 when auditing the fair value of investments; Subsequent footnotes further renumbered.
Renumbered paragraph 2.168 (renumbered footnote 48)	Revised to reflect how SAS No. 70 and related interpretations were affected by SAS No. 98 amendments.
Paragraphs 2.170–2.178	Added to incorporate SAS No. 101 guidance; Subsequent paragraphs further renumbered.
Former paragraphs 2.132–2.135	Deleted; Subsequent paragraph further renumbered.

Reference	Change
Paragraph 3.01	Revised to add FASB Interpretation No. 45 and No. 46 to the list of standards that should be considered in connection with financial instruments of investment companies; Deleted footnote * about an exposure draft that would amend FASB Statement No. 133; Listed FASB Statement No. 149 among the FASB Statements amending FASB Statement No. 133; Inserted footnote * to alert readers about FASB Statement No. 149's issuance and effective date.
Paragraph 3.31	Added to alert readers that freestanding written put options are within the scope of the disclosure provisions of FASB Interpretation No. 45; Subsequent paragraphs renumbered.
Paragraphs 4.21 (footnote 5) and 4.53 (footnote 7)	Revised to alert readers about the issuance of SAS No. 98 which, among other things, amends SAS No. 70.
Chapter 5	Revised to add "funds of funds" to the list of illustrative financial statements presented in the Guide.
Chapter 5 (title)	Footnote * added to alert readers about the issuance of FASB Interpretation No. 46.
Paragraph 5.20	Revised to clarify the verbiage based on the comments from one of the industry experts.
Paragraph 5.46 (footnote *)	Added to alert readers about the issuance of an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, which could impact the financial ratios of Fund of Funds as well as the disclosures of restrictions on redemptions, investment objectives and fees of investee funds.
Paragraph 5.57	Revised to remove the word "first" from the sentence, "All shareholder purchases and redemptions are recorded first at the feeder level," based on the comments from one of the industry experts. "First" implies they should be recorded at the master later, which is untrue. Shareholder transactions are *only* recorded by the entity engaging in them.
Paragraph 5.67 (footnote 4)	Added to alert readers about the issuance of SAS No. 101.
Paragraph 5.77	Revised to change "the auditor should consider performing tests with respect to feeder fund tax compliance" to "the auditor should test feeder fund tax compliance" based on the comments from one of the industry experts. As written, it seems to suggest that there may not be a need to test compliance by a feeder while there shouldn't be any less (or more) requirement to test compliance for a feeder than for a stand-alone fund.

Reference	Change
Paragraph 5.83 (footnote 5)	Added to alert readers about the issuance of SAS No. 101.
Paragraph 7.01 (footnote *)	Added to alert readers about the issuance of an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. The verbiage of this footnote was revised to be consistent with the verbiage of the exposure draft.
Paragraph 7.04 (footnote *)	Added to alert readers about the issuance of FASB Interpretation No. 46.
Paragraph 7.05 (footnote *)	Deleted footnote about an exposure draft on special-purpose entities since the final pronouncement has been issued at this point.
Paragraph 7.10	Footnote 8 revised to alert readers about the rule proposed by the SEC which could substantially change the regulatory requirements for reporting the schedule of investments in reports to shareholders; Deleted footnote * about an exposure draft of a FASB Statement amending FASB Statement No. 133 because the final statement has been issued and it does not affect FASB Statement No. 107.
Paragraph 7.11 (footnote *)	Added to alert readers about the rule proposed by the SEC which could substantially change the regulatory requirements for reporting the schedule of investments in reports to shareholders.
Paragraph 7.12	Footnote * added to alert readers about the issuance of an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships; Footnote 14 added to alert readers about the issuance of Auditing Interpretation No. 16 of SAS No. 58; Subsequent footnotes renumbered.
Paragraph 7.20	Revised to delete reference to "organization costs" and to delete former footnote 16 referring to paragraphs discussing such costs because SOP 98-5 was issued five years ago and all deferred organization costs allowed to remain in transition should now be fully amortized; Subsequent footnotes further renumbered.
Paragraphs 7.28 and 7.31 (footnotes *)	Added to alert readers about the issuance of FASB Statement No. 150.

Reference	Change
Paragraph 7.65	Footnote 24 added to reference the issuance of applicable Inquiries and Replies and citations to where they appear in the literature (this footnote was removed from paragraph 7.68 and placed here for better visibility); Footnote * added to alert readers about the issuance of two exposure drafts of proposed SOPs which address reporting of financial highlights by non-registered investment partnerships and separate accounts.
Paragraph 7.68 (former footnote 24)	Deleted and incorporated in footnote 24 in paragraph 7.65.
Paragraph 7.71	Deleted footnote * about an exposure draft that would amend FASB Statement No. 133; Listed FASB Statement No. 149 among the FASB Statements amending FASB Statement No. 133; Added footnote * to alert readers about FASB Statement No. 149's issuance and effective date.
Paragraph 7.75	Added to alert readers about the issuance of SAS No. 100; Subsequent paragraphs renumbered.
Renumbered paragraph 7.86 (notes 3, *Call Options Written*, and 8, *Portfolio Securities Loaned, Financial Futures Contracts, and Forward Currency Contracts*)	Revised footnotes * to insert "and related amendments" after FASB Statement No. 133 to indicate that readers also need to consider the amendments of FASB Statement No. 133.
Paragraph 8.21	Deleted because SOP 98-5 was issued five years ago and all deferred organization costs allowed to remain in transition should now be fully amortized; Subsequent paragraphs renumbered.
Renumbered paragraph 8.27 (footnote *)	Added to alert readers about the adoption of Form N-CSR.
Renumbered paragraph 8.34	Revised to insert "frequently" to account for a 10 percent-of-assets "de minims" test which, in a number of cases, exempts an N-14 from the requirement to provide pro-forma financials.
Former paragraph 8.38 and footnote 5	Deleted because SOP 98-5 was issued five years ago and all deferred organization costs allowed to remain in transition should now be fully amortized; Subsequent paragraphs further renumbered; Subsequent footnote renumbered.
Renumbered paragraph 8.44	Revised to alert readers about the issuance of SAS No. 98 which, among other things, amends SAS No. 8.
Paragraph 9.02	Revised to clarify the verbiage based on the comments from one of the industry experts.

Reference	Change
Paragraph 9.11 (footnote 1)	Added to alert readers about the adoption of a new Form N-CSR; Subsequent footnotes renumbered.
Chapter 10 (title)	Footnote * added to alert readers about the issuance of an exposure draft of a proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies.
Paragraph 10.30	Revised to clarify the verbiage based on the comments from one of the industry experts.
Paragraph 10.53	Revised (and footnote 4 deleted) to delete reference to SEC Forms S-6/N-8B-2 since at this point they have been replaced by the Form N-6; Subsequent footnotes renumbered.
Paragraph 10.58 (note 6, *Unit Values*)	Footnote * added to alert readers about the issuance of an exposure draft of a proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies.
Paragraph 11.02 (footnote 2)	Added to alert readers about the issuance of Auditing Interpretation No. 14, "Reporting on Audits Conducted in Accordance with Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of SAS No. 58; Subsequent footnotes renumbered.
Paragraphs 11.03–11.05 and footnotes 4 and 5	Added to incorporate guidance from Auditing Interpretation No. 16 of SAS No. 58; Subsequent paragraphs renumbered; Subsequent footnotes further renumbered.
Renumbered paragraph 11.12 (footnote 16)	Added to alert readers about the issuance of SAS No. 101; Subsequent footnotes further renumbered.
Renumbered paragraph 11.13	Footnote 18 added to alert readers about the issuance of SAS No. 100; Subsequent footnotes further renumbered; Revised the report to conform to a sample report in SAS No. 100.
Renumbered paragraphs 11.14 and 11.15 (footnotes *)	Deleted footnote about the issuance and effective date of SSAE No. 11 since it is effective at the present time.
Renumbered paragraph 11.15 (footnote *)	Added to alert readers about a new proposed SEC rule, *Custody of Funds or Securities of Clients by Investment Advisers*.
Renumbered paragraph 11.17 (footnote *)	Deleted footnote about the issuance and effective date of SSAE No. 11 since it is effective at the present time.
Renumbered paragraph 11.18	Renumbered footnote 29 revised to alert readers about the issuance of SAS No. 98 which, among other things, amends SAS No. 70; Footnote 31 added to alert readers about the issuance of Auditing Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods," of SAS No. 70; Subsequent footnotes further renumbered.

Reference	Change
Renumbered paragraphs 11.19 and 11.20 (footnotes *)	Deleted footnote about the issuance and effective date of SSAE No. 11 since it is effective at the present time.
Renumbered paragraph 11.23	*Item 5* (and footnotes *): Replaced with items 5, 6, 7, 8, and 9 to revise sample representation letter to reflect that SAS No. 99 amended SAS No. 85 and to include an additional representation (item 8 and footnote 34) consistent with the requirements of the Sarbanes-Oxley Act; Subsequent items renumbered; Subsequent footnotes further renumbered; *Renumbered item 10b*: Footnote * added to alert readers about the issuance of FASB Interpretation No. 45; *Item 12*: Revised based on suggestions from one of the industry experts; *Item 14a*: Footnote 36 added to alert readers that SAS No. 101 lists several representations about fair value measurements and disclosures contained in the financial statements that the auditor may consider obtaining from management.
Paragraph 11.24	Added to alert readers about the affect of certification requirements of the Sarbanes-Oxley Act on the management representation letter; Subsequent paragraph further renumbered.
Paragraph 12.01 (and footnote *)	Revised to delete the effective date information (from the footnote) about FASB Statement No. 144 since FASB Statement No. 144 is effective at the present time, to alert readers about the issuance of FASB Interpretation No. 46, and to update the status of AcSEC's project to clarify the scope of this Guide.
Paragraphs 12.20 (footnote *) and 12.21 (footnote **)	Added to alert readers about the issuance of an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships.
Glossary	Revised certain definitions, based on the comments from one of the industry experts, to reflect recent industry and regulatory developments.

Glossary

401(k) plan. A plan by which an employee may elect, as an alternative to receiving taxable cash as compensation or bonus, to contribute pretax dollars to a qualified tax-deferred retirement plan.

accumulation unit. The basic valuation unit of a deferred variable annuity. Such units are valued daily to reflect investment performance and the prorated daily deduction for expenses.

adjustable rate mortgage (ARM). A mortgage loan whose interest is reset periodically to reflect market rate changes.

adviser. See **investment adviser**.

advisory and service fee (contract). The fee charged to an investment company by its investment adviser under a contract approved by vote of a majority of the company's shares. The fee is computed as a percentage of the average net assets, and may also provide for an additional bonus or penalty based on performance. (See **incentive fee**.)

affiliated company. Under sections 2(a)(2) and 2(a)(3) of the Investment Company Act of 1940, a company in which there is a direct or indirect (*a*) ownership of, control of, or voting power over 5 percent or more of the outstanding voting shares or (*b*) control of or by, or common control under, another company or persons. (See **controlled company**.)

against the box. Short sale by the holder of a long position in the same stock.

American depository receipt (ADR). A certificate issued by an American bank to evidence ownership of original foreign shares. The certificate is transferable and can be traded. The original foreign stock certificate is deposited with a foreign branch or correspondent bank of the issuing American bank.

amortization. In the context of a bond held as an asset, the systematic reduction of the difference between the price of a bond purchased at a discount or premium and the par value of the bond.

amortized cost. A method of valuation, discussed in rule 2a-7 of the Investment Company Act of 1940, in which a portfolio security is carried at cost and any discount or premium from par is amortized to income on a daily basis over the life of the instrument.

annuity contract. A contract issued by an insurance company that provides payments for a specified period, such as for a specified number of years, or for life. (See **variable annuity**.)

as-of transaction. A transaction recorded on the books of an investment company after the date on which the transactions should have been recorded. This term relates to shareholder purchases and redemptions, and also portfolio security purchases and sales.

asked price. A potential seller's lowest declared price for a security.

asset allocation. Apportioning of investment funds among categories of assets, such as cash equivalents, stocks, and fixed income instruments.

baby bond. A bond having a par value of less than $1,000, usually $25 to $500. Also refers to the distribution of additional bonds instead of cash payments in connection with interest payable on a payment-in-kind (PIK) bond or similar security. (Also known as bunny bonds.)

banker's acceptance. A time or sight draft drawn on a commercial bank by a borrower, usually in connection with a commercial transaction. The borrower is liable as is the bank, which is the primary obligor, to pay the draft at its face amount on the maturity date.

basis point. A measurement of changes in price or yields for fixed-income securities. One basis point equals .01 percent, or ten cents per $1,000 per annum.

bid price. The highest declared price a potential buyer is willing to pay for a security at a particular time.

bifurcation. The separation of underlying factors relating to a transaction initially measured in one currency and reported in a second currency. Any difference between originally recorded amounts and currently consummated or measured amounts can be split into changes in the foreign exchange rate and changes in foreign currency denominated fair value.

Blue Sky laws. State laws governing the sale of securities, including mutual fund shares, and activities of brokers and dealers within the particular state, and applicable also in interstate transactions having some substantial connection with the state.

board-contingent 12b-1 plan. A 12b-1 plan that provides that, upon termination of the plan, the investment company's board of directors has the option of paying the distributor for costs incurred by the distributor in excess of the cumulative contingent deferred sales loads and 12b-1 fees the distributor has received. (See **rule 12b-1**.)

bond discount. The difference between the face amount of a bond and the lower price paid by a buyer.

bond premium. The difference between the face amount of a bond and the higher price paid by a buyer.

book entry shares. Share ownership evidenced by records maintained by a transfer agent rather than by physical stock certificates.

break point. A quantity of securities purchased at which a lower sales charge takes effect; also, an aggregate amount of investment company assets in excess of which a lower rate of investment advisory fee is chargeable.

broker. An agent, often a member of a stock exchange firm or an exchange member, who executes orders to buy or sell securities or commodities and charges a commission. (See section 2(a)(6) of the Investment Company Act of 1940.)

business development company (BDC). A company defined in section (2)(a)(48) of the Investment Company Act of 1940 as a closed-end investment company that chooses to be treated as a BDC under the Act, and is operated to make investments in *eligible portfolio companies*, follow-on investments in former eligible portfolio companies acquired by the company when the investee was an eligible portfolio company, and investments in certain bankrupt or insolvent companies.

call option. A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price (strike price) either on (European-style) or at any time until (American-style) the stated expiration date of the contract. The option, which is transferable, is bought in the expectation of a price rise above the strike price. If the price rises, the buyer exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There is a listed and also an over-the-counter market in options. During the existence of an option, the exercise price and underlying number of shares are adjusted on the exercise date for cash dividends, rights, and stock dividends or splits.

callable. Redeemable by the issuer before the scheduled maturity. The issuer must pay the holders a premium price if such a security is retired early. Such securities are usually called when interest rates fall so significantly the issuer can save money by floating new bonds at lower rates.

capital gain dividend. Under section 852 of the Internal Revenue Code (and as used in chapter 6 of this Guide), a dividend designated as paid from long-term capital gain as determined for federal income tax purposes. In non-tax contexts, however, this term is used interchangeably with *capital gains distribution*.

capital gain or loss. A profit or loss realized from the sale of capital assets, such as portfolio securities, as defined in section 1221 of the Internal Revenue Code.

capital gains distribution. A dividend paid to investment company shareholders from net capital gains realized by a regulated investment company on the disposition of portfolio securities. (See section 19(b) and rules 19a-1 and 19b-1 of the Investment Company Act of 1940.)

CBOE. Abbreviation for Chicago Board Options Exchange, a national securities exchange based in Chicago that provides a continuous market for trading in put and call options. Various other exchanges (such as the American, Pacific and Philadelphia) also provide such markets.

certificates of deposit. Short-term, interest-bearing, certificates issued by commercial banks or by savings and loan associations against funds deposited in the issuing institution.

CFTC. Abbreviation for Commodity Futures Trading Commission, an agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants. Among other things, this agency establishes rules governing the minimum financial, reporting and audit requirements of its members. Its function is similar to that performed by the SEC in regulating broker-dealers in securities and various securities markets.

classes of shares. Securities offered by an investment company with different shareholder requirements and commitments. For example, class A shares may be sold with a front-end load, while class B shares may be sold with a 12b-1 asset-based charge and a contingent deferred sales load.

clearing agency. A central location at which security transactions of members are matched to determine the quantities to be received or delivered.

closed-end fund. An investment company having a fixed number of shares outstanding, which it does not stand ready to redeem. Its shares are traded similarly to those of other public corporations. (See section 5(a) of the Investment Company Act of 1940.)

collateralized mortgage obligation (CMO). A mortgage-backed bond that separates mortgage pools into different maturity classes called tranches. Each tranche is then sold separately.

commercial paper. Short-term, unsecured, promissory notes issued by corporations. Commercial paper is usually sold on a discount basis. (See section 3(a)(3) of the Securities Act of 1933 and section 3(a)(10) of the Securities Exchange Act of 1934.)

common (collective) trust fund. An account maintained by the trust department of a bank or trust company for the pooling of investment funds of its own trust account customers, exempt from the Investment Company Act of 1940 under section 3(c)(3) or 3(c)(11).

compensation plan. A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.

contingent deferred sales charge (CDSC). A charge related to an issuer's payments for distribution pursuant to a rule 12b-1 plan. It is imposed only on redemption and may be reduced or eliminated as the duration of ownership continues.

contingent deferred sales load (CDSL). A sales charge, imposed directly on redeeming shareholders, based on a percentage of the lesser of the redemption proceeds or original cost. The percentage may decrease or be eliminated based on the duration of share ownership (frequently decreases by 1 percent a year). (Also known as a back-end load.)

contractual plan. A type of accumulation plan under which the total intended investment is specified with provisions for periodic payments over a stated period. Such plans are sometimes called **front-end load plans** because a substantial portion of the sales charge applicable to the total investment is usually deducted from early payments. (See sections 2(a)(27) and 27 of the Investment Company Act of 1940 concerning periodic purchase plans.)

control. Defined by section 2(a)(9) of the Investment Company Act of 1940 as the power to exercise (whether exercised or not) a controlling influence over the management or policies of a company, unless that power results solely from an official position with the company.

controlled company. Defined by the Investment Company Act of 1940 as a direct or indirect ownership of more than 25 percent of the outstanding voting securities of a company. (See **affiliated company**.)

convertible securities. Securities carrying the right (either unqualified or under stated conditions) to exchange the security for other securities of the issuer or of another issuer. Most frequently applies to preferred stocks or bonds carrying the right to exchange for given amounts of common stock.

corporate actions. An action by a company's board of directors, including dividend declarations, reorganizations, mergers, and acquisitions.

corporate bonds. Debt instruments issued by private corporations as distinct from those issued by government agencies or municipalities. Corporate bonds have three distinguishing features: (1) they are taxable; (2) they normally have a par value of $1,000; and (3) they have a term maturity.

CUSIP (number). A means of uniformly describing and identifying specific security issues in numeric form. Developed by the Committee on Uniform Security Identification Procedure.

custodian. A bank, trust company, or, less frequently, a member of a national securities exchange, responsible for receiving delivery and for the safekeeping of an investment company's cash and securities. (See section 17(f) of the Investment Company Act of 1940.)

DTC. Acronym for Depository Trust Company. A depository for eligible securities that facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates.

DVP. Abbreviation for *delivery versus payment*, under which physical possession and ownership are transferred only upon cash payment.

daily limits. Limits established by exchanges on fluctuations in prices of futures contracts (other than the current month's delivery contracts) during a trading session.

dealer. A person or firm acting as a principal rather than as an agent in buying and selling securities. Mutual fund shares are frequently sold through dealers. (See section 2(a)(11) of the Investment Company Act of 1940.)

declaration date. The day on which the board of directors or, if so authorized, a committee of the board announces a distribution of cash or other specified assets to be paid at a specified future time to shareholders of record on a specified record date. The amount of distribution is usually specified on a per share basis, although investment company distributions are occasionally specified in an aggregate amount to assure the desired federal income tax consequence.

deemed dividend. A dividend not paid in cash or other consideration. For a regulated investment company, the term is used in connection with net realized long-term capital gains that are retained undistributed, in whole or in part, by the regulated investment company and on which it pays the federal income tax on behalf of shareholders as a whole. Each shareholder reports his or her share of the deemed dividend as a long-term capital gain and receives a credit against his or her federal income tax liability for his or her share of the tax paid by the regulated investment company, and also an increase in basis of those shares. (See **designated capital gain**.)

deficiency dividend. A special dividend attributable to the underdistribution of taxable income paid by a regulated investment company to protect its special tax status.

delayed delivery contract. A transaction for which delivery and payment are longer than the usual regular-way transaction.

depositor. A person other than the trustee or custodian who is primarily responsible for the organization of a unit investment trust that deposits the portfolio with (that is, sells the portfolio to) the trustee and who has certain continuing responsibilities in administering the affairs of that trust. (See sections 17(a)(1)(C) and 26 of the Investment Company Act of 1940.)

designated capital gain. A term used by a regulated investment company to refer to its election to retain long-term capital gains realized during the year. (See **deemed dividend**.)

distributions. Dividends paid from net investment income and realized capital gains. (See **capital gains distribution**.)

distributor. Usually the principal underwriter who sells the mutual fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public. (See definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940.)

diversification. Investment of a portfolio in securities that have different kinds of investment risk, in order to moderate the portfolio's overall risk of loss. Most commonly refers to diversification by securities issuer, but can also be used in reference to industry exposure, creditworthiness or quality of security issuers taken as a whole, or, in international portfolios, exposure to national (or regional) economies. Sometimes the term may be used in reference to security kinds (for example, fixed-income versus equity securities).

diversified investment company. A management investment company having at least 75 percent of its total assets in cash and cash items (including receivables), government securities, securities of other investment companies, and other securities limited to not more than 5 percent of its total assets in any one issuer and not more than 10 percent of the voting securities of any one issuer in accordance with section 5(b)(1) of the Investment Company Act of 1940.

dividends. Pro rata payments to shareholders, typically from earnings. In the context of investment companies, applied to payments derived from net investment income and realized capital gains. (See **distributions**.)

dollar roll. A series of securities transactions where an investment company purchases a mortgage-backed security (such as a *TBA* or terms to be announced) and concurrently sells that security for settlement at a future date.

eligible portfolio company. Defined by section 2(a)(46) of the Investment Company Act of 1940 as any U.S. organized company that is not itself an investment company and that either (1) does not have a class of securities registered on a national securities exchange or eligible for margin purchase under Federal Reserve Board rules or (2) is actively controlled by a business development company (BDC), either alone or as part of a group acting together, and has an affiliate of the BDC on its board of directors. In most instances it must be a company to which the BDC extends significant managerial assistance, either through the exercise of control or through an arrangement whereby the BDC, acting through its directors, officers, and employees, provides significant guidance and counsel concerning the management, operations, or business objectives and policies of the company.

enhanced 12b-1 plan. After termination of this plan, the investment company's board of directors is required to continue paying 12b-1 fees to the distributor for costs incurred by the distributor but not paid by the fund. (See **rule 12b-1**.)

equalization. An accounting method used to prevent a dilution of the continuing shareholders' per share equity in undistributed net investment income caused by the continuous sales and redemptions of capital shares.

equity securities. A term referring to common and preferred stocks and debentures convertible into common stocks.

eurodollars. U.S. dollars deposited in banks outside the United States.

evaluator. One who determines the daily or periodic value per unit for unit investment trusts.

ex-dividend or ex-distribution date. Synonym for *shares being traded without dividend or without capital gains distribution.* The buyer of a stock selling ex-dividend does not acquire a right to receive a previously declared but not-yet-paid dividend. Dividends are payable on a fixed date to shareholders recorded on the stock transfer books of the disbursing company as of a previous date of record. (See **record date.**) For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Because three business days are allowed for delivery of the security in regular-way transactions on a stock exchange or over-the-counter, the exchange or the NASD declares the stock ex-dividend as of the opening of the market on the preceding Wednesday or on one business day earlier for each intervening nontrading day. Therefore, anyone buying the stock on and after Wednesday is not entitled to the dividend. For nontraded shares of mutual funds, the ex-dividend date is the same as the record date.

exchange. An organized forum for the trading of securities or commodities by members for their own accounts or the accounts of their customers. The most active domestic securities exchanges are the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX); the most active domestic commodities exchanges are the Chicago Board Options Exchange (CBOE) and the Chicago Mercantile Exchange (the Merc).

excise tax. A 4 percent tax imposed if a regulated investment company (RIC) fails to make minimum distributions to shareholders each calendar year. The required distribution is the sum of 98 percent of net investment income for the calendar year and 98 percent of capital gain net income for the 12 months ended October 31. The difference between actual distributions and the required distribution is subject to the tax. If the RIC distributed less than 100 percent of income in a prior year, the shortfall increases the current year required distribution.

expense limitation. An agreement between an investment company and its investment adviser, in which the adviser agrees to limit its advisory fee or the total expenses of the company to an amount that is usually based on a stipulated relationship between total expenses and average net assets. Limitations may be either contractual or voluntary.

ex-rights. Similar to ex-dividend. The buyer of a stock selling ex-rights is not entitled to a rights distribution.

ex-warrants. Stocks or bonds trading without attached warrants, entitling holders to subscribe to additional shares within specified periods and at specified prices.

face amount certificate company. An investment company, as defined by section 28 of the Investment Company Act of 1940, that issues installment-type certificates as defined by section 2(a)(15) of the Act.

fail to deliver. Securities that the selling broker or other financial institution has not delivered to the buyer at the settlement or clearance date.

fail to receive. Securities that the buying broker or a financial institution has not received from the seller at the settlement or clearance date.

fair value. The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

fixed income security. A preferred stock or debt security with a stated percentage or dollar income return.

flat. A method of trading in certain kinds of bonds, usually income bonds that do not pay interest unless it has been earned and declared payable or bonds on which the issuing corporation has defaulted in paying interest. The seller of a bond trading flat is not entitled to receive the interest that has accrued since the date of the last interest payment and delivers the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect interest, if any, which may be paid by the issuing corporation in the future.

forward foreign exchange contract. An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.

forward placement commitment contract. An over-the-counter contract for delayed delivery of securities in which the buyer agrees to buy and the seller agrees to deliver a specified security at a specified price at a specified future date.

forward pricing. The pricing of mutual fund shares for sale, repurchase, or redemption at a price next computed after an order has been received. Mutual fund shares are usually priced once or twice a day.

futures contract. A transferable agreement to deliver or receive during a specific future month a standardized amount of a commodity of standardized minimum grade or a financial instrument of standardized specification under terms and conditions established by the designated contract market.

guaranteed investment contract (GIC). Nontradeable contract that guarantees return of principal and a specific minimum rate of return on invested capital over the life of the contract. Many contracts also provide for withdrawals of principal at par at specified dates and/or upon specified conditions before maturity. Most frequently used by pension and retirement plans where withdrawals are permitted to fund retirement benefits, payments to employees leaving the company, or transfers of benefits among investment options.

hedge fund. An investment company seeking to minimize market risks or maximize returns by holding securities believed likely to increase in value and simultaneously being short in securities believed likely to decrease in value. The only objective is capital appreciation. Hedge funds also may use leverage techniques.

hedging. A means of risk protection against loss due to adverse price fluctuations by buying or selling a futures contract or option to offset a present or anticipated position or transaction in the cash market.

hypothecate. To pledge securities to brokers as collateral for loans made to purchase securities or cover short sales.

illiquid. Not readily convertible into cash, such as a stock, bond, or commodity that is not actively traded, and would be difficult to sell in a current sale. Not more than 15 percent of a mutual fund's net assets (10 percent for money market funds) may be invested in illiquid securities.

inadvertent investment company. An industrial or service company deemed to be an investment company because it inadvertently meets the criteria of section 3(a) of the Investment Company Act of 1940 and must register under that Act and comply with its provisions. Under the Investment Company Act of 1940, also known as a transient investment company.

incentive allocation. A partnership allocation based upon the fund's performance reallocating profits from the capital account of a limited partner to the capital account of a general partner. The incentive may be an absolute percentage of the fund's performance or a percentage of performance in excess of a specified benchmark.

incentive fee. A fee paid to an investment adviser based upon the fund's performance for the period. The incentive may be an absolute share of the fund's performance or a share of performance in excess of a specified benchmark. For registered investment companies offered to the general public, any performance fee must be based on a comparison of performance to a specified index, and must provide for an equivalent penalty if the performance fails to match the index return.

index. A statistical composite that measures changes in the economy or in financial markets.

index option. Calls or puts on indexes of stock.

indexed security. A security whose value is based on the absolute or relative value, over a period of time or at a point in time, of a financial indicator, such as a measure of interest rates, exchange rates, commodity prices, or stock prices.

indexing. Constructing a portfolio to match the composition or performance of a broad-based index.

initial margin deposit. A commodity transaction term, meaning the amount of money or its equivalent, specified by the commodity exchange under which the contract is traded, held as a good faith deposit to make sure that the customer meets the variation margin requirement. Maintenance margin refers to additional deposits. (See **margin**, a securities transaction term.)

interest method. A method of amortizing discount or premium on debt that results in a constant rate of interest on the sum of the face amount of debt and the unamortized premium or discount at the beginning of each period.

interested person. Under section 2(a)(19) of the Investment Company Act of 1940, a person affiliated with an investment company; a member of his or her immediate family (as defined); a person affiliated with the company's investment adviser or principal underwriter; an investment company's legal counsel; any broker or dealer or its affiliated persons; and any other person as so determined administratively by the SEC based on relationships.

inverse floater. A floating rate note in which the rate paid increases (decreases) at a multiple of declines (rises) in the floating market rate.

investment adviser (manager). Under section 2(a)(20) of the Investment Company Act of 1940, a company providing investment advice, research, and often administrative and similar services for a contractually agreed-on fee, based on a percentage of net assets.

Investment Advisers Act of 1940. Provides for the registration and regulation of most persons who render investment advice to individuals or institutions, including investment companies, for compensation.

investment advisory agreement. An agreement between an investment company and an investment manager, engaging the investment manager to provide investment advice to the investment company for a fee. (See sections 15(a), 15(c), and 36(b) of the Investment Company Act of 1940.)

investment company. An entity that pools shareholders' funds to provide the shareholders with professional investment management.

Investment Company Act of 1940. Provides for the registration and regulation of investment companies.

investment company trade associations. Such associations as the Investment Company Institute (ICI), the National Investment Company Service Association (NICSA), the Mutual Fund Education Alliance, the National Association of Small Business Investment Companies (NASBIC), and the Association of Publicly Traded Investment Funds (composed of closed-end companies).

investment grade bonds. Bonds rated by a rating service in one of its top four categories (AAA to BBB/Baa).

investment partnership. A partnership, usually a limited partnership, organized under state law to invest and trade in securities.

junk bonds. Bonds with a rating of BB/Ba or lower, issued by a company without a long record of sales and earnings or with questionable credit strength. Common kinds include step-interest, and payment-in-kind bonds. (Also known as high-yield bonds.)

letter of intent. An agreement by which a shareholder agrees to buy a specified dollar amount of mutual fund shares, usually over thirteen months, in return for a reduction in the sales charge applicable to a comparable lump sum purchase.

leverage. Borrowing to enhance return. Buying securities on margin is an example of leverage.

LIBOR (London Interbank offered rate). The rate of interest that the most creditworthy international banks dealing in eurodollars charge each other for large loans. Various instruments' rates are tied to LIBOR.

liquidity. A measure of the ease with which a security trades in large blocks without a substantial drop in price.

listed security. A security listed and traded on a stock exchange.

long. Denotes ownership or right to possession of securities.

management fee. An amount charged by an investment adviser under a contract approved by the holders of a majority of a registered investment company's outstanding shares. The fee may gradually decline as a fixed or reducing percentage of the average net assets and may also provide for an additional bonus (or penalty) based on performance. (See **incentive fee.**)

management investment company. Under section 4(3) of the Investment Company Act of 1940, a management company (often referred to as a management investment company) is defined as any investment company, other than a face amount certificate company (as defined in section 4(1)) or a unit investment trust (as defined in section 4(2)). The term management company is sometimes used to refer to the investment adviser of an investment company.

margin. A securities transaction term, meaning the amount of money or its equivalent, specified by the Board of Governors of the Federal Reserve System, that a customer must deposit with a broker in a securities transaction on margin. (See **initial margin deposit**, a commodity transaction term.)

margin account. A means of leveraging offered by security brokers or dealers to permit their customers to buy securities in part with borrowed funds. The difference between the price of a security and equity provided by the customer is loaned by the broker or dealer to the customer.

mark-to-market. A procedure to adjust the carrying value of a security, option, or futures contract to fair value.

market price. Usually the last reported price at which a security has been sold or, if the security was not traded or if trading prices are not reported, a price arrived at based on recent bid and asked prices.

matrix pricing. A technique relying on extrapolation used to value normal institutional size trading units of debt securities without relying exclusively on quoted prices. Factors such as the issue's coupon or stated interest rate, maturity, rating, and quoted prices of similar issues are considered in developing the issue's current market yield.

money market fund. A mutual fund whose investments are primarily or exclusively in short-term debt securities designed to maximize current income with liquidity and capital preservation, usually maintaining per share net asset value at a constant amount, such as one dollar.

money market investments. Short-term government obligations, commercial paper, bankers acceptances, and certificates of deposit that may be bought at their face amount or at a discount or premium from their face amount.

mortgage backed security (MBS). A pass-through security created by pooling mortgages and selling interests or participation in the MBS. The mortgage originator usually continues to service the underlying mortgages while passing through principal and interest payments received from the mortgagors. (See paragraphs 3.16 and 3.17).

municipal bond fund. An investment company whose shares represent holdings solely or largely of securities on which interest is exempt from federal income taxes.

municipal notes and bonds. Securities that are issued by states, cities, and other local government authorities to fund public projects. The interest on these bonds is normally exempt from federal taxes and under certain conditions is exempt from state and local taxes. Municipal notes usually mature in less than three years.

mutual fund. The popular name for an open-end management investment company. (See **open-end investment company**.)

NASDAQ. An electronic quotation system for over-the-counter securities sponsored by the National Association of Securities Dealers (NASD), which, for securities traded on the NASD National Market System, reports prices and shares or units of securities trades in addition to other market information.

National Association of Securities Dealers, Inc. (NASD). An association of brokers or dealers, registered as such under section 15A of the Securities Exchange Act, that supervises and regulates trading conducted by its members.

net assets. The term used by an investment company to designate the excess of the fair value of securities owned, cash, receivables, and other assets over the liabilities of the company.

net asset value per share. The value per share of outstanding capital stock of an investment company, computed (usually daily by mutual funds) by dividing net assets by the total number of shares outstanding. (See rule 2a-4 of the Investment Company Act of 1940.)

no-action letter. A letter issued to an Investment Adviser or Investment Company (Registrant) by the staff of the Securities and Exchange Commission (SEC) in response to a request filed by the Registrant describing a proposed business activity that may or may not conform to SEC rules and regulations. In a no-action letter, the SEC staff indicates whether, based on the facts presented by the Registrant, the SEC staff will recommend no action be taken against the Registrant for engaging in the proposed activity. A no-action letter does not have the force of law; however, it represents an interpretation of the SEC staff that may be applied in a situation where the Registrant is engaging in an activity not addressed by existing SEC rules and regulations.

no-load fund. A mutual fund selling and redeeming its shares at net asset value without adding sales charges, although some such funds have rule 12b-1 plans permitting payment of distribution expenses with fund assets. A mutual fund may not call itself "no-load" if a 12b-1 fee is levied exceeding 0.25 percent of fund assets per year. Investors deal directly with the fund, not through an investment dealer or broker.

nondiversified investment company. A management investment company other than a diversified company, as defined in section 5(b) of the Investment Company Act of 1940.

NSCC. Abbreviation of National Securities Clearing Corporation, an independent organization established by the New York and American Stock Exchanges and the National Association of Securities Dealers as an equally owned subsidiary to provide trade processing, clearance, delivery, and settlement services to its members. It deals with brokers, dealers, and banks in the United States and Canada.

NYSE. Acronym for New York Stock Exchange. A not-for-profit corporation that is the largest securities exchange in the United States. This self-regulatory organization also furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

offering price. The price at which mutual fund shares or investment trust units can be bought, often equaling net asset value plus a sales load.

offset. A closing transaction involving the purchase or sale of an option or futures contract having the same features as one already held. This could be a hedge, such as a short sale of a stock, to protect capital gain, or the purchase of a futures contract to protect a commodity price, or a straddle representing the purchase of offsetting put and call options on a security.

offshore fund. An investment company organized outside the United States, whose shares are offered solely to foreign investors.

open contract. An unperformed or unsettled contract. May be used in referring to new issues traded *when, as, and if issued* or in referring to commodity futures trading. The term is used to designate contracts bought or sold, still outstanding, or delivered or offset.

open-end investment company. A mutual fund that is ready to redeem its shares at any time and that usually offers its shares for sale to the public continuously. (See section 5(a)(1) of the Investment Company Act of 1940.)

original issue discount. A federal income tax term for interest to the holder of a bond that represents the difference between the face amount of a bond and its original sales price.

over-the-counter (OTC). A market for securities of companies not listed on a stock exchange and traded mainly by electronic communications such as NASDAQ or by phone. The over-the-counter market is the principal market for U.S. government bonds and municipal securities.

passive foreign investment company (PFIC). A foreign corporation is a PFIC if either (1) 75 percent of its gross income is passive, or (2) 50 percent or more of the average value of its assets, computed quarterly, produce or could produce passive income, as defined in the Internal Revenue Code.

payable date. The date on which a dividend is payable to holders of record on some previous record date.

payment-in-kind (PIK) bond. A type of high-yield debt instrument whose issuer has the option of making interest payments either in cash or in additional debt securities.

penny-rounding method. A method permitted by rule 2a-7 of the Investment Company Act of 1940, under which the net asset value per share of a money market fund is computed based on the fair values of all investments and then rounded to the nearest 1 percent.

performance fee. See **incentive fee**.

periodic payment plan. See **accumulation unit** and sections 2(a)(27) and 27 of the Investment Company Act of 1940.

personal holding company. An income tax term, defined as a corporation of which 60 percent of adjusted ordinary gross income is personal holding company income, as defined in the Internal Revenue Code, and five or fewer individuals own more than 50 percent in value of its outstanding stock during the last half of the taxable year.

point. A rise or decline of one dollar per share, used to refer to the purchase or sale of stocks. If used for the purchase or sale of bonds, the term means a rise or decline of $10 per $1000 principal amount. A basis point is one hundredth of one percent of the principal amount.

portfolio. Securities owned by an investment company or other investor in securities.

portfolio turnover rate. A measure of portfolio activity, calculated for an investment company by dividing the lesser of purchases or sales of securities, excluding securities having maturity dates at acquisition of one year or less, by the average value of the portfolio securities held during the period. (See Form N-SAR, instructions to item 11, and Forms N-1A, Item 9, Instruction 4(d), and Form N-2, Item 4, Instruction 17.)

premium on redemptions (repurchases). See **redemption (repurchase) fee (or charge)**.

price make-up sheet. A detailed computation of the net asset value of a mutual fund.

principal. A person, especially a dealer, who buys or sells securities for his or her own account. Also refers to the face amount of a security without accrued interest.

principal underwriter. See **distributor** and definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940.

private placement. The direct sale of a block of securities of a new or secondary issue to a single investor or group of investors. The sale or placement is usually made through an investment banker and the securities' public resale restricted if they are not registered under the Securities Act of 1933. (See **restricted security**.)

prospectus. A circular required by the Securities Act of 1933 describing securities being offered for sale to the public. (See section 2(a)(31) of the Investment Company Act of 1940.)

proxy. A person authorized to vote the shares of an absent shareholder at a meeting of shareholders. Also refers to the written authorization given to that person. (See section 20(a) of the Investment Company Act of 1940.)

proxy statement. A publication sent to stockholders by a board of directors, or its adversaries, or others, usually containing financial reports (for merger and other financial proposals), stockholders' meeting notices, and voting information on certain matters to solicit proxies from the holders. (See rules 20a-1, 20a-2, and 20a-3 under the Investment Company Act of 1940, and regulation 14A under the Securities Exchange Act of 1934.)

put option. A contract entitling the holder to sell (put), at his or her option, a specified number of shares or units of a particular security at a specified price (strike price) at any time until the contract's stated expiration date. The option, which is for a round lot and may or may not be transferable, is bought on the expectation that the price will decline below the strike price. If the price declines below the strike price, the buyer exercises or sells the option. If the price does not decline below the strike price, the buyer lets the option expire and loses only the cost of the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an equity option are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

real estate mortgage investment conduit (REMIC). An investment vehicle created to hold fixed-rate pools of mortgages and to issue two classes of interest in the REMIC: regular interest and residual interests. The vehicle is not subject to taxation and may be used to protect investors in mortgage-related instruments from double taxation.

realized gain or loss. See **capital gain or loss**.

record date. The date on which an owner of a share of stock must be registered on the books of a company as a shareholder to receive a declared dividend or, among other things, to vote on company affairs.

recordkeeping agent. An outside service bureau, bank, or other agency engaged by an investment company to maintain records of purchases and sales of investments, sales and redemptions of fund shares, and shareholders' account statements.

redemption. A stockholder's tender of investment company shares to the company or person designated by the company, requiring liquidation of such shares in exchange for proceeds, usually in cash, representing the net asset value of the shares tendered, occasionally less a *redemption fee*. (See section 2(a)(32) of the Investment Company Act of 1940.)

redemption in kind. Redemption of investment company shares by payment in portfolio securities, not cash. Permissible in certain circumstances for many mutual funds and tax-free exchange funds. (See rule 18f-1 under the Investment Company Act of 1940.)

redemption or repurchase price. The price, net asset value, less a redemption fee, at which a share of a mutual fund is redeemed or repurchased. (See section 2(a)(32) of the Investment Company Act of 1940.)

redemption (repurchase) fee (or charge). A percentage of net asset value that may be charged to the investor on redemptions or repurchases of an open-end investment company's shares. (See section 10(d)(4) of the Investment Company Act of 1940.)

registered investment company. An investment company that has filed a registration statement with the SEC as an investment company in accordance with requirements of the Investment Company Act of 1940. The investment company, as defined in section 3(a) of the Act, primarily invests, reinvests, or trades in securities (section 3(a)(1)), issues face-amount certificates (section 3(a)(2)), or engages in investing and owning investment securities, other than government securities, that have a value exceeding 40 percent of the company's total assets (section 3(a)(3)), with some exceptions to the latter (stated in section 3(b)).

registrar. An institution, often a bank, that countersigns stock certificates and is responsible for preventing the issuance of more stock than authorized by the board of directors and the charter of the issuing company. (See **transfer agent**.)

regulated investment company (RIC). An investment company that qualifies for the special tax treatment provided for by subchapter M of the Internal Revenue Code.

Regulation S-X. Accounting rules for form and content of financial statements and schedules required under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1940, and the Energy Policy and Conservation Act of 1975. Article 6 applies to financial statements, and specified rules in article 12 apply to financial schedules, of investment companies.

reimbursement plan. A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of contingent deferred sales load (CDSL) received by the distributor.

repurchase. Liquidation of investment company shares through a principal underwriter or a broker-dealer on behalf of shareholders, sometimes for a purchase or service charge or a brokerage commission.

repurchase agreement. An agreement under which an investment company pays for and receives *(purchases)* securities from a *seller* who agrees to repurchase them within a specified time at a specified price. A repurchase agreement is known on the side of a selling broker-dealer or other seller as a reverse repurchase agreement.

restricted security. A portfolio security that may be sold privately, but that is required to be registered with the SEC or to be exempted from such registration before it may be sold in a public distribution. A private placement stock is frequently referred to as *letter stock*.

return. See **yield.**

return of capital. Distributions by investment companies in excess of tax-basis earnings and profits.

reverse repurchase agreement. An agreement under which the investment company transfers *(sells)* securities for cash to another party *(purchaser)*, usually a broker, and agrees to repurchase them within a specified time at a specified price. A reverse repurchase agreement is known in the broker-dealer industry as a repurchase agreement. (See paragraph 3.6.)

right. A privilege offered by a corporation to its shareholders pro rata to subscribe to a certain security at a specified price, often for a short period. Rights may or may not be transferable.

right of accumulation. A method permitting aggregation of mutual fund shares being acquired with shares previously acquired and currently owned to qualify for a quantity discount that reduces the sales charge on a single purchase.

rule 2a-7. A rule under the Investment Company Act of 1940 that permits money market funds to value investments at amortized cost or through the use of the penny-rounding method.

rule 12b-1. A rule under section 12 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under conditions prescribed therein. (See **board-contingent 12b-1 plan** and **enhanced 12b-1 plan**.)

rule 144A. A rule under the Securities Act of 1933 that provides a safe harbor exemption from the registration requirements for resales of restricted securities to "qualified institutional buyers."

sale against the box. Similar to a short sale, except that the seller already owns the stock being sold but keeps possession of it and therefore has to borrow the equivalent stock to deliver to the purchaser.

sales charge. An amount providing for the underwriter's and dealer's commission that is added to the net asset value of an open-end investment company's shares in computing the offering price and stated as a percentage of the offering price. A sales charge can also be imposed on redemption.

section 4(2). A section of the Securities Act of 1933 that exempts transactions by an issuer not involving a public offering from registration under that Act.

Securities Act of 1933. Principal federal law regulating the public offering of corporate securities. Among other things, regulates contents of prospectuses and similar documents and is intended to ensure that potential investors receive adequate information to make reasonably informed investment decisions.

Securities and Exchange Commission (SEC). An agency established by Congress to administer federal securities laws.

Securities Exchange Act of 1934. Regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets.

securities lending. The practice of lending portfolio securities, usually to a broker to cover a short sale. The loan is usually collateralized by cash or government securities.

seed money. An initial amount of capital contributed to a company at its inception. (See section 14(a) of the Investment Company Act of 1940.)

senior equity security. Any stock of a class having a priority over any other class as to distribution of assets or payment of dividends.

separate account. An account established and maintained by an insurance company that holds particular assets allocated to that account, and is credited or charged with income, gains, or losses from these assets separately from income, gains, or losses of the insurance company's general accounts. Sometimes referred to as a *variable account*, a separate account funds variable annuities or variable life insurance policies. Although it is not an entity but is only an account within the insurance company, it may be an investment company within the meaning of the Investment Company Act of 1940. (See section 2(a)(37) of the Act.)

series fund. An investment company that offers multiple segregated portfolios of common stock. (See rule 6-03(j) of Regulation S-X.)

settlement date. The date on which security transactions are settled by delivering or receiving securities and receiving or paying cash pursuant to an earlier agreement of purchase and sale called a trade. (See **trade date**.)

short. A stock record position representing the physical location of a security (such as box, transfer, and so forth), or meaning that the security is due from others (such as failed-to-receive, or owed to the brokerage concern by a customer due to a short sale).

short sale. A sale of securities that requires borrowing equivalent securities to make delivery to the purchaser.

SIPC (Securities Investor Protection Corporation). A federal corporation established under the Securities Investor Protection Act that provides insurance against loss by customers of brokers or dealers who are in financial difficulty.

Small Business Administration (SBA). An agency established by Congress to administer the Small Business Investment Company Act of 1958.

Small Business Incentive Act of 1980. Amends the Investment Company Act of 1940 by, among other things, allowing closed-end companies to elect to be regulated as business development companies under the newly enacted section 2(a)(48) and sections 54-65 of the Investment Company Act of 1940. (See **business development company**.)

Small Business Investment Company Act of 1958. Authorizes the Small Business Administration to provide government funds to small business investment companies licensed under that Act.

small business investment company (SBIC). An investment company, registered under the Small Business Investment Company Act of 1958, established to provide capital to small business enterprises.

spread. A combination of put and call options for the same quantity of a security at different prices. Also refers to the difference between the bid and asked prices of a security and to the dealer's commission on a security offering.

standby commitment contract. An agreement to accept future delivery of a security at a guaranteed price or fixed yield on exercise of an option held by the other party to the agreement.

step bond. A type of high-yield debt instrument with deferred interest payments, or whose interest rate resets at specific times during its term.

stock dividend. A dividend payable in the stock of the issuing corporation.

stock split. An increase in the number of outstanding shares of a company's stock to decrease the market price and thus allow for greater distribution of the shares. For example, ownership of two shares for each share previously held tends to reduce the price of each share by approximately half, assuming no other concurrent changes, such as in the rate of dividend.

stop loss order. An order used by a customer to protect an unrealized profit in a security or to limit a possible loss in a security. The stop order becomes a market order when the price of the security reaches or sells through the price specified by the customer.

straddle. A combination of one put and one call option, identical to the security issue, number of shares, exercise price, and expiration date.

stripping. The brokerage practice of separating a fixed income security into its corpus and its coupons, which are then sold separately.

structured note. A type of debt instrument with a customized coupon that pays based on equal, proportional, or leveraged increases (or decreases) in interest or currency rates, commodity indexes, or specific securities' fair values.

synthetic floaters. A derivative instrument which uses interest payments from long-term municipal bonds, which may be coupled with an interest rate swap and put features, to pay a floating short-term interest rate.

synthetic coupon security. A security created by the combination of two or more other securities.

TBA. Abbreviation for *to be announced* future government sponsored enterprises' pools that are bought and sold for future settlement. TBA refers to the announcement of the specific pools to be delivered or received.

tender offer. A public offer to buy from all current holders not less than a specified amount of an issuer's securities at a fixed price.

total return. A periodic measure of a fund's overall change in value, which assumes the reinvestment of dividends and capital gain distributions. (Total return is a standardized method prescribed by the SEC as described in item 22 of Form N-1A.)

trade. An agreement of purchase and sale in a securities market, to be settled or performed by payment and delivery on a later settlement date.

trade date. The date a security transaction is actually entered into, to be settled on a later settlement date.

traditional 12b-1 plan. A compensation or reimbursement plan pursuant to rule 12b-1 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued upon plan termination, but may continue to be paid after plan termination under a board-contingent plan.

transfer. A change of ownership of a security by delivery of certificates for the security in a sale (against payment of the purchase price in a securities market sale), or by gift, pledge, or other disposition. A subsequent registration of the transfer in the securities transfer records of the issuer is not a part of the transfer itself.

transfer agent. An agent who keeps records of the names of the company's registered shareholders, their addresses, and the number of shares they own. The agent must be sure that certificates presented to the office for transfer are canceled and that new certificates are issued in the name of the transferee. (See **registrar**.)

undertaking. An agreement between a registrant and the Securities and Exchange Commission (SEC) staff in connection with the filing of a registration statement, whereby the registrant agrees to take a future action requested by the staff but not otherwise necessarily or expressly required by the securities' statutes, but (in a federal registration) that may be required by SEC rules, or by SEC forms that have the same legal status as the rules by which they were adopted.

underwriting. The act of distributing a new issue of securities (primary offering) or a large block of previously issued securities (secondary offering). A "firm commitment" underwriting obligates the underwriter to purchase the underwritten securities, regardless of whether or not they can be resold. A "best efforts" underwriting only obligates the underwriter to act as agent for the sale of the issuer's stock to the extent ultimate purchasers appear.

unit investment trust. An investment company, organized under a trust indenture, that issues only redeemable securities, each of which represents an undivided interest in a unit of specified (usually unmanaged) securities. (See section 26 of the Investment Company Act of 1940.)

unlisted security. A security that is not listed on a securities exchange. (See **over-the-counter**.)

unrealized appreciation or depreciation. The excess (appreciation) or deficiency (depreciation) of the fair value of securities over (under) their cost.

unregistered securities. Securities that are not registered under the Securities Act of 1933.

variable annuity. An annuity having a provision for the accumulation of an account value, for benefit payments, or both, that vary according to the investment experience of the separate account to which the amounts paid for the annuity are allocated.

variation margin. A term used in commodity operations. Refers to last-day point fluctuation—a difference between the settling price of the day before and the last day's settling price—on net positions long and short.

venture capital investment company. A closed-end investment company whose primary investment objective is capital growth and whose capital is usually invested wholly or largely in restricted securities in negotiated transactions to form or develop companies with new ideas, products, or processes.

warrant. A type of option to purchase additional securities from the issuer. Commonly affixed to the certificates for other securities at the time when the combined securities units are originally issued, and usually separable, sometimes on and after a subsequent date. Also, a document evidencing options to purchase shares.

wash sale. A sale of stock or other securities in which a taxpayer has acquired or entered a contract or option to acquire substantially identical stock or other securities within a period beginning thirty days before and ending thirty days after the date of the sale (a sixty-one day period). A loss resulting from such a sale is not deductible for federal income tax purposes, but a gain is taxable. (See section 1091 of Internal Revenue Code.)

when-issued. A short form designation for *when, as, and if issued.* The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers rules that the transactions are to be settled.

yield. The return on investment that an investor receives from dividends or interest expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price paid. Yield also may refer to the SEC yield, a standardized yield calculation method prescribed by the SEC based upon interest and dividend income of the fund. (See item 22 of the instructions to Form N-1A.)

yield to maturity. The rate of return on a debt security held to maturity, giving effect to the stated interest rate, accrual of discount, and amortization of premium.

zero coupon bond. A type of debt instrument that makes no periodic interest payment, but is issued at a deep discount from its face value. The holder derives his or her return from the gradual appreciation in the value of the security, which redeems at face value at a specified maturity date.